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# Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight

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# EVALUATING BEPS: A RECONSIDERATION OF THE BENEFITS PRINCIPLE AND PROPOSAL FOR UN OVERSIGHT

REUVEN S. AVI-YONAH\*

HAIYAN XU\*\*

*The Financial Crisis of 2008 and Great Recession that followed have exacerbated income inequality within and between countries. In the aftermath of the economic turbulence, politicians have turned their attention to the twin problems of individual tax evasion and corporate tax avoidance. U.S. legislators enacted the Foreign Account Tax Compliance Act (FACTA), leading to the United States signing a series of Intergovernmental Agreements (IGAs) for the exchange of tax information. The Organization for Economic Co-operation and Development (OECD) developed the Multilateral Agreement for Administrative Assistance in Tax Matters (MAATM) and initiated the Base Erosion and Profit Shifting (BEPS) project to reduce tax evasion and tax avoidance globally. Although these efforts were well-intended, this Article argues that the tax policy response to the Financial Crisis and Great Recession has ultimately been inadequate. The problem, which is discussed in-depth in the sections that follow, is the benefits principle.*

*Part I of this Article introduces the primary weakness of the benefits principle: the reliance on source-based taxation for active income and residence-based taxation for passive income requires cooperation by too many jurisdictions. This section provides three case studies of individual tax evasion and corporate tax avoidance to illustrate the principle's shortcomings. Part II focuses on the individual tax evasion problem. This section analyzes the FATCA, IGA, and MAATM responses and explains why these measures are likely to fall short. Part III focuses on corporate tax avoidance. This section examines the BEPS response and its inadequacies. Part IV proposes an alternative to international tax policy based on the benefits principle. This section argues that reversing the benefits principle by taxing passive income primarily at source and active income primarily at residence will more effectively reduce individual tax evasion and corporate tax avoidance in the developed and developing world.*

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INTRODUCTION

The Financial Crisis of 2008 and the Great Recession that followed have raised anew the problem of how to address growing inequality within and between countries. These intra- and inter-country dimensions of inequality have widened in this century, and the Great Recession has made both problems worse. The current rise of populism in the United States and Eu-

rope and the vehement reactions to a tide of migrants from poorer to richer countries show how these two problems are intertwined.<sup>1</sup>

Sixteen years ago, the first author examined the challenge that globalization and tax competition pose to the fiscal viability of the post-World War II welfare state.<sup>2</sup> He argued that if tax evasion by rich individuals and tax avoidance by multinational enterprises (MNEs) continues to undermine the ability of developed and developing countries to provide adequate social insurance for their citizens, a violent reaction against globalization may end the current era of open borders, just like World War I curtailed globalization a century ago. In 2016, we worry that the inadequate tax response to the Great Recession is escalating anti-globalization sentiments, embodied in the United States by the success of Bernie Sanders and Donald Trump, and in Europe by an even more virulent rejection of the European Union's open border policies.<sup>3</sup>

Following the Financial Crisis and ensuing austerity, politicians have turned their attention to the twin problems of tax evasion and tax avoidance. On the individual tax evasion front, U.S. legislators enacted the Foreign Account Tax Compliance Act (FATCA) in 2010. This law led to the signing of Intergovernmental Agreements (IGAs) between the United States and 115 other countries (and counting) for the exchange of tax information. The IGAs led the Organization for Economic Co-operation and Development (OECD) to develop Common Reporting Standards (CRS) and the Multilateral Agreement for Administrative Assistance in Tax Matters (MAATM), which has been adopted by over eighty countries (though only signed but not ratified by the United States).<sup>4</sup>

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<sup>1</sup> See, e.g., Peggy Noonan, Opinion, *Trump, Sanders and the American Rebellion*, WALL ST. J. (Feb. 11, 2016), <http://on.wsj.com/1QavpWY>.

<sup>2</sup> See Reuven S. Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, 113 HARV. L. REV. 1573 (2000).

<sup>3</sup> See Noonan, *supra* note 1; *Why is EU Struggling With Migrants and Asylum?*, BBC NEWS (Mar. 3, 2016), <http://www.bbc.com/news/world-europe-24583286>.

<sup>4</sup> On FATCA, IGAs and MAATM, see generally Allison Christians, *What You Give and What You Get: Reciprocity Under a Model 1 Intergovernmental Agreement on FATCA*, 31 CAYMAN FIN. REV. 24 (2013), <http://ssrn.com/abstract=2292645>; Allison Christians, *The Dubious Legal Pedigree of IGAs (and Why it Matters)*, 69 TAX NOTES INT'L 565 (2013), <http://ssrn.com/abstract=2280508>; Itai Grinberg, *Taxing Capital Income in Emerging Countries: Will FATCA Open the Door?*, 5 WORLD TAX J. 325 (2013), <http://ssrn.com/abstract=2256587>; Itai Grinberg, *The Battle Over Taxing Offshore Accounts*, 60 UCLA L. REV. 304 (2012), <http://ssrn.com/abstract=2497998>; J. Richard Harvey, Jr., *Offshore Accounts: Insider's Summary of FATCA and its Potential Future*, 57 VILL. L. REV. 471 (2012), <http://ssrn.com/abstract=1969123>; Susan C. Morse, *Why FATCA Intergovernmental Agreements Bind the U.S. Government*, 70 TAX NOTES INT'L 245 (2013), <http://ssrn.com/abstract=2252843>; Susan C. Morse, *Ask for Help, Uncle Sam: The Future of Global Tax Reporting*, 57 VILL. L. REV. 529 (2012), <http://ssrn.com/abstract=1999101>; Reuven S. Avi-Yonah & Gil Savir, *IGAs vs. MAATM: Has Tax Bilateralism Outlived its Usefulness?* (Univ. of Mich. Pub. Law, Research Paper 384, 2014), <http://ssrn.com/abstract=2392702>; Joshua D. Blank & Ruth Mason, *Exporting FATCA* (N.Y. Univ. Law and Econ., Working Paper No. 14-05, 2014), *reprinted in* 142 TAX NOTES 1245 (2014), <http://ssrn.com/abstract=2389500>; Itai Grinberg, *Beyond FATCA: An Evolutionary Moment for the International Tax System* (Georgetown Law Faculty, Working Paper No. 160, 2012), [http://scholarship.law.georgetown.edu/fwps\\_papers/160](http://scholarship.law.georgetown.edu/fwps_papers/160); J. Richard

On the corporate tax avoidance front, the OECD and G20 launched the Base Erosion and Profit Shifting (BEPS) project in 2013, culminating with the release of a series of action reports in October 2015.<sup>5</sup> Commenting on the project, OECD Secretary-General Angel Gurría stated:

Base erosion and profit shifting affects all countries, not only economically, but also as a matter of trust. BEPS is depriving countries of precious resources to jump-start growth, tackle the effects of the global economic crisis[,] and create more and better opportunities for all. But beyond this, BEPS has been also eroding the trust of citizens in the fairness of tax systems worldwide. The measures [presented in the action reports] represent the most fundamental changes to international tax rules in almost a century: they will put an end to double non-taxation, facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning structures ineffective.<sup>6</sup>

Is Mr. Gurría justified in his optimism? We think not. As the Article discusses in the sections that follow, the benefits principle is the problem. Under the benefits principle, active (business) income is taxed primarily at source, while passive (investment) income is taxed primarily at residence.<sup>7</sup> Formed in 1923, this compromise between the claims of residence and

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Harvey, Jr., *FATCA - A Report From the Front Lines* (Villanova Law Pub. Policy, Working Paper No. 2013-3001, 2012), reprinted in 136 TAX NOTES 713 (2012), <http://ssrn.com/abstract=2122491>.

<sup>5</sup> On BEPS, see, e.g., Pascal Saint-Amans and Raffaella Russo, *The BEPS Package: Promise Kept*, 70 IBFD Bulletin for International Taxation 4 (2016); Hugh J. Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, 70 TAX NOTES INT'L 1195 (2013); Itai Grinberg, *Breaking BEPS: The New International Tax Diplomacy*, GEO. L. J. (forthcoming), <http://ssrn.com/abstract=2652894>; Adam H. Rosenzweig, *Building a Framework for a Post-BEPS World*, 74 TAX NOTES INT'L 1077 (2014); Richard J. Vann, *Policy Forum: The Policy Underpinnings of the BEPS Project—Preserving the International Corporation Income Tax*, 62 CAN. TAX J. 433 (2014); Hugh J. Ault et. al., *Base Erosion and Profit Shifting: A Roadmap for Reform* (Bos. Coll. Law Sch., Working Paper No. 324, 2014), <http://ssrn.com/abstract=2459646>; Yariv Brauner, *What the BEPS?* (Univ. of Fla. Coll. of Law, Legal Studies Working Paper No. 15-40, 2014), <http://ssrn.com/abstract=2408034>; Dhammika Dharmapala, *Base Erosion and Profit Shifting: A Simple Conceptual Framework* (Univ. of Chi. Law Sch. Coase-Sandor Inst. for Law & Econ., Working Paper No. 703, 2015), <http://ssrn.com/abstract=2497770>; Dhammika Dharmapala, *What Do We Know About Base Erosion and Profit Shifting? A Review of the Empirical Literature* (Univ. of Chi. Law Sch., Coase-Sandor Inst. for Law & Econ., Working Paper No. 702, 2014), <http://ssrn.com/abstract=2373549>; Daniel Shaviro, *The Crossroads Versus the Seesaw: Getting a 'Fix' on Recent International Tax Policy Developments* (N.Y. Univ. Sch. of Law, Pub. Law & Legal Theory Research Paper Series, Working Paper No. 15-20, 2015), <http://ssrn.com/abstract=2605144>.

<sup>6</sup> Centre for Tax Policy and Administration, *OECD Presents Outputs of OECD/G20 BEPS Project for Discussion at G20 Finance Ministers Meeting*, ORG. FOR ECON. CO-OPERATION & DEV. (Oct. 5, 2015), <http://www.oecd.org/ctp/oecd-presents-outputs-of-oecd-g20-beps-project-for-discussion-at-g20-finance-ministers-meeting.htm>.

<sup>7</sup> On the benefits principle and its origins, see REUVEN S. AVI-YONAH, *ADVANCED INTRODUCTION TO INTERNATIONAL TAX LAW* ch. 1 (2015); Reuven S. Avi-Yonah, *International Taxation of Electronic Commerce*, 52 TAX L. REV. 507 (1997); Reuven S. Avi-Yonah, *The*

source countries still serves as the foundation of the international tax regime.<sup>8</sup> It is embedded in over 3000 bilateral tax treaties as well as the domestic laws of the United States and most other countries. In accordance with the benefits principle, FATCA, the IGAs, and MAATM are designed to enforce residence-based taxation of passive income, while BEPS represents an attempt to improve source-based taxation of active income.<sup>9</sup> Against this orthodoxy, this Article reconsiders the benefits principle and offers modifications of existing policies to develop a more effective international tax regime.

Part I introduces the primary weakness of the benefits principle: the reliance on source-based taxation for active income and residence-based taxation for active income requires cooperation by too many jurisdictions. This section provides three case studies of individual tax evasion and corporate tax avoidance to illustrate the principle's shortcomings. Part II focuses on the individual tax evasion problem. This section analyzes the FATCA, IGA, and MAATM responses and explains why these measures are likely to fall short. Part III focuses on corporate tax avoidance. This section examines the BEPS response and its inadequacies. Part IV proposes an alternative to international tax policy based on the benefits principle. This section argues that reversing the benefits principle by taxing passive income primarily at source and active income primarily at residence will effectively reduce individual tax evasion and corporate tax avoidance in the developed and developing world.

## I. ILLUSTRATING THE TAX EVASION AND TAX AVOIDANCE PROBLEMS

Taxation at residence is traditionally justified because most passive income is earned by individuals whose residences are relatively easy to determine. However, tax havens provide secret avenues for the flow of funds from the residence countries to the countries in which the funds are invested. Since the relaxation of exchange controls in the 1980s, tax competition to attract funds has led source jurisdictions to abolish withholding taxes on such income. Consequently, a wealthy person can route her investment through a tax haven conduit, resulting in no taxation at source (because there are no withholding taxes) or at residence (because the residence country does not know about the investment given secrecy in the tax haven). Preventing this erosion of the tax base through the exchange of information

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*Structure of International Taxation: A Proposal for Simplification*, 74 TEX. L. REV. 1301 (1996).

<sup>8</sup> See Avi-Yonah, *The Structure of International Taxation: A Proposal for Simplification*, *supra* note 7.

<sup>9</sup> On FATCA, IGAs and MAATM, see, e.g., Blank & Mason, *Exporting FATCA* *supra* note 4. On BEPS, see, e.g., Ault, *Some Reflections on the OECD and the Sources of International Tax Principles*, *supra* note 5.

as envisaged by the MAATM would require the cooperation of every tax haven.

Taxation at source has been justified because active income is generally earned by corporations that have no fixed residence. However, since the 1980s, tax competition has led many source jurisdictions to offer tax holidays to MNEs, while residence jurisdictions have become reluctant to tax MNEs on their global income to remain competitive without other jurisdictions. As a result, most MNEs are not taxed at source or residence. Reducing this tax avoidance would likewise require the cooperation of countries that currently compete with each other to provide tax holidays. Three recent examples illustrate the tax evasion and tax avoidance on cross border income that results from the shortcomings of the benefits principle:<sup>10</sup>

#### A. *Individual Tax Evasion—Sam Wyly*<sup>11</sup>

Sam Wyly is a rich Texas businessman. In 2006, Forbes estimated his net worth as \$1.1 billion. He and his brother Charles made their money in computers, a steakhouse chain, and Michael's Arts and Crafts, which they bought in 1982 and sold in 2006 to a group of private equity firms, including Bain Capital, for \$6 billion. Sam is a major philanthropist: a \$10 million gift resulted in the naming of Sam Wyly Hall at the University of Michigan Ross School of Business. He is also an avid Republican. In 2004, Sam Wyly helped finance the "Swift Boat" ad campaign that scuttled John Kerry's bid for the presidency.

But Sam Wyly is now bankrupt. In 2006, a hearing of the U.S. Senate Permanent Subcommittee on Investigations (PSI) revealed that he had been evading U.S. tax laws by hiding his money in trusts in the Isle of Man, a notorious tax haven. He began by transferring stock options from his various companies to the trusts, which were managed by Isle of Man trustees. The nominal trust beneficiaries were two foreign charities, but the six Wyly children were contingent beneficiaries, and the trustees understood that at Sam's death the children would become the true beneficiaries and collect the funds.

In the meantime, the trusts were free to exercise the stock options and use the stock for investments, with the understanding that ten years down the road they would have to make annuity payments to Sam. Sam obtained an opinion from a law firm that this arrangement worked to defer taxes on the income gained from exercising the options until he began receiving annuity payments years later. But the linchpin of the legal opinion was that the offshore trusts were independent actors when, in fact, Sam exercised total con-

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<sup>10</sup> The examples in sections I.A. and I.B. appear in Reuven S. Avi-Yonah, *International Tax Evasion and Avoidance: What Can Be Done?* THE AMERICAN PROSPECT, (May 26, 2016), <http://prospect.org/article/international-tax-evasion-what-can-be-done>. The examples have been reprinted in this Article with minor editing to conform to the *Harvard Business Law Review* style requirements.

<sup>11</sup> See *supra* text accompanying note 10.

trol over the trust assets, secretly using the investment profits to operate businesses and buy real estate, jewelry, and artworks in the United States. The Wyllys' secret control over their offshore funds was revealed in the PSI hearing.

In 2010, the Securities and Exchange Commission (SEC) charged Sam and Charles Wyly with securities fraud based on Sam's hidden control of the offshore trusts. In 2014, a jury found him liable. To avoid paying a \$300 million judgment, he filed for bankruptcy, which triggered a tax assessment for his failing to pay any taxes on hundreds of millions of dollars in offshore income since 1992. After a prolonged court battle, in June 2016, a federal judge in Texas ordered Wyly to pay \$1.1 billion in taxes and penalties.<sup>12</sup>

How many Wyllys are hiding their money from the IRS, with no PSI hearing to bring their misdeeds to light? We will probably never know. A recent estimate of the global costs of illegal tax evasion by the economist Gabriel Zucman was \$200 billion, but this is probably too low since estimates for the United States alone range from \$20 billion to \$70 billion. Every time a Swiss banker talks, many billions in U.S. tax evasion are revealed. The IRS Offshore Voluntary Disclosure Program has netted over \$6 billion and counting.

And this is only for illegal tax evasion by individual taxpayers. Because the evasion hides taxable income, it is hard to quantify with any precision.

Corporations are another story, because what they are doing is legal tax avoidance—manipulating their books to avoid taxation—and therefore the magnitudes can be better quantified. As of the end of 2015, U.S.-based MNEs had more than \$2 trillion in offshore profits in low-tax jurisdictions. This amount, which translates to about \$700 billion in U.S. taxes avoided, is mostly income that was economically earned in the United States and shifted offshore to jurisdictions like Singapore, Ireland, or Luxembourg, which have effective tax rates in the single digits.

### *B. Corporate Tax Avoidance—Apple and Caterpillar<sup>13</sup>*

How do the MNEs avoid taxes? A couple of examples can suffice. Apple Inc. is the world's largest company by market capitalization. Most of its billions in profits relate to intellectual property developed at its headquarters in Cupertino, California. But for tax purposes, most of the profit is booked in its Irish subsidiaries—which we will call Apple Ireland.

Some of the profit-shifting is achieved through a "cost sharing agreement." Cost sharing is a concept developed in IRS regulations in the 1980s, but it became more significant due to the increasing importance of intellec-

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<sup>12</sup> Katy Stech, *Judge Hands Entrepreneur Sam Wyly a \$1.1 Billion Tax Bill*, WALL ST. J. (June 28, 2016), <http://www.wsj.com/articles/judge-hands-entrepreneur-sam-wyly-a-1-1-billion-tax-bill-1467144226>.

<sup>13</sup> See *supra* text accompanying note 10.



tual property. The idea behind cost sharing is this: when a U.S.-based MNE begins a new research project (for example, a search for a drug to treat a certain disease), it can agree to share the costs of development with its offshore subsidiaries. Then, if the project is successful, the parties share the profits in the same proportions. For example, if Apple Ireland contributed 80% of the costs of developing the iPhone 6, it would get 80% of the profit. Importantly, none of the actual work is done by Apple Ireland. Apple just gives Apple Ireland the money and Apple Ireland pays it back as its contribution to the research costs.

Why would the IRS regulations permit this? Because if the research failed, then the taxpayer would lose its ability to deduct the costs sent offshore. The more of the cost sent offshore, the more deductions would be at risk. So the IRS thought there was a natural limit to taxpayer willingness to share costs with offshore affiliates.

That analysis may have been true for Big Pharma, which usually waits to enter into cost sharing with an offshore affiliate until a drug has passed its initial trials and is well on its way to a patent, and then battles the IRS over valuation issues at the time the cost-sharing agreement was executed. But the same analysis makes less sense for Apple, since it faces lower R&D risk for its new products, such as the iPhone 6, than Big Pharma companies do for their new drugs.

There is another trick involved in Apple Ireland's profitability. Another portion of its profits derive from countries where Apple sells the iPhones. Apple Ireland licenses the right to use Apple's brand and intellectual property to Apple affiliates in other countries. Those affiliates in turn pay Apple Ireland hefty royalties, which operate to shift the sales profits gained in those countries to Ireland.

Before 1997, such a scheme would not have worked, because the royalties received by Apple Ireland would have triggered a tax in the United States under so-called Subpart F, which was designed to prevent foreign corporations from taking advantage of inconsistencies between U.S. and foreign tax law. But in 1997, the Clinton administration adopted a rule called "check the box." Under "check the box," Apple Ireland can, for U.S. tax purposes, treat all of its foreign affiliates as if they did not exist as separate entities, and treat the money they paid to Apple Ireland as income earned in Ireland. The result is that, for U.S. tax purposes, there are no royalties and no U.S. tax triggered by them, because Apple Ireland treats the money as its own sales income.

The Obama administration came in promising to repeal "check the box;" this was the biggest international revenue raiser in the first Obama budget. But by its next budget in 2010, the administration recanted under pressure from the MNEs. Recently, Obama signed into law a five-year extension of a provision (first enacted by a Republican Congress as a "temporary" measure in 2006) that enshrines "check the box" in the tax law.

Finally, the PSI hearing revealed two Irish-specific tricks used by Apple. Ireland has a tax rate of 12.5 percent, far below the U.S. rate of 35 percent. But Apple did not want to pay even 12.5 percent. Its solution: for U.S. tax purposes, Apple Ireland is treated as an Irish company because it is incorporated in Ireland, so it is not taxed by the United States. But for Irish tax purposes, Apple Ireland was treated as an American company because it is “managed and controlled” from California. As a result, Apple Ireland claimed it was a tax resident nowhere. On top of that, Apple negotiated a sweetheart tax deal with Ireland for its Irish income, which resulted in its paying a tax rate of less than 2%.

These types of tricks are used by most U.S.-based MNEs. If the primary driver of value of a U.S.-based MNE is intellectual property developed in the United States, the Apple scheme can simply be replicated.

But what if the value derives from more traditional, tangible items? Some U.S.-based MNEs do pay higher taxes (e.g., car companies). But others try to avoid tax nevertheless. Caterpillar Inc. is a good example.

Caterpillar does not make a lot of money on the heavy equipment it manufactures. But it does profitably sell replacement parts. Before 1999, Caterpillar bought the parts from unrelated manufacturers and stored them at its warehouse in Morton, Illinois. When a dealer requested a part for a customer overseas, Caterpillar “sold” (but did not actually ship) the part to a Swiss subsidiary, which in turn sold the part to the unrelated dealer.

The problem, according to accounting firm PricewaterhouseCoopers (PwC), was that Caterpillar’s sale of the part to its Swiss subsidiary triggered U.S. taxes. Much better, PwC said, would be if the parts were sold by the manufacturer directly to the Swiss subsidiary, which could then sell them to the dealer. The result was that Caterpillar continued to run its parts business from the United States, but declared 85% or more of the parts profits in Switzerland.

In addition, PwC came up with a way to lower Caterpillar’s U.S. tax without requiring Caterpillar to change its operations. PwC’s solution was for the manufacturers to bill the Swiss subsidiary for the parts but continue to ship them to the Illinois warehouse, which continued to transport them to Caterpillar’s foreign customers. If the parts were shipped overseas, they were deemed to have been “owned” by the Swiss subsidiary, and PwC devised a virtual inventory to track them, even though the parts were indistinguishably commingled in the warehouse. The result was that Caterpillar continued to run its parts business from the United States, but declared 85% or more of the parts profits in Switzerland.

The IRS has now challenged this billing arrangement, which resulted in shifting some \$2.4 billion in Caterpillar profits from the United States to Switzerland. A grand jury has issued subpoenas under a criminal investigation for tax fraud.

But the disturbing fact is that the whole story would not have come to light but for a whistleblower, who alerted both PSI and the IRS. And while

Caterpillar is facing a court challenge, in most cases of corporate tax avoidance, like Apple, the IRS's hands are tied, because what Apple did may have been legal under the U.S. tax code.

### C. *Assessing the Tax Evasion and Tax Avoidance Problems*

The problem with this state of affairs is that the progressive income tax cannot be maintained in the absence of taxing cross-border flows. The wealthy can more easily earn cross-border income. The result has been a worldwide shift to taxing consumption rather than income. But consumption taxes are regressive and cannot by definition reach the unconsumed income of the rich.<sup>14</sup> Without progressive taxation, it will not be possible to maintain the public's commitment to social insurance that is globalization's main defense against growing inequality.

To preserve the income tax in the twenty-first century, multilateral solutions are needed. MAATM and BEPS are both multilateral, but they are hampered by the fact that there are too many residence jurisdictions for passive income and source jurisdictions for active income. If we reversed the benefits principle, so that passive income is taxed primarily at source and active income at residence, far fewer jurisdictions will need to cooperate.

For passive income, the number of source jurisdictions is much smaller than residence jurisdictions. Portfolio investment flows overwhelmingly to a small number of jurisdictions—the United States, the European Union, and Japan. Even Brazil, Russia, India, China, and South Africa (BRICS) mostly attract portfolio investment through mutual funds that are relatively easy to tax. Thus, if the “big three” can coordinate to reinstate a withholding tax on interest, dividends and royalties flowing from them, most of the problem of taxing passive income can be solved. Crucially, money cannot stay in tax havens and earn decent rates of return, so the cooperation of tax havens is not needed, unlike in the case of the MAATM. For active income, about 90% of MNEs are headquartered in the G20, and none of those countries have a tax rate below 20%, so if they taxed their MNEs currently on a coordinated basis and restricted the ability to move out most of the problem would be resolved.<sup>15</sup>

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<sup>14</sup> On the shift to consumption taxes, see Reuven S. Avi-Yonah, *Tax Competition*, *supra*; note 2. On the inability of consumption taxes to reach the unconsumed income of the rich, see Reuven S. Avi-Yonah, *Why Tax the Rich? Efficiency, Equity, and Progressive Taxation*, 111 YALE L. J. 1391, 1407 (2002) (reviewing Joel B. Slemrod, *Does Atlas Shrug? The Economic Consequences of Taxing the Rich* (2000)); Reuven S. Avi-Yonah, *Risk, Rents and Regressivity: Why the United States Needs Both an Income Tax and a VAT*, 105 TAX NOTES 1651, 1653 (2004).

<sup>15</sup> For the location of the world's 100 largest MNEs, see Liyan Chen, *The World's Largest Companies 2015*, FORBES (May 6, 2015), <http://www.forbes.com/sites/liyanchen/2015/05/06/the-worlds-largest-companies/#4ebf4ea14fe5> (89% are in G20 countries). For the tax rates of the G20, see HM Treasury, Budget 2012, H.C. 1853, at 33 (Mar. 21, 2012).

We suggest reconsidering the benefits principle in light of the reality of globalization. We should tax passive income primarily at source and active income primarily at residence. Importantly, this approach does not preclude the alternative. Once passive income is taxed at source, taxpayers may be able to credit the tax upon declaring it to their residence country. In parallel, once active income is taxed at residence, a credit can be given to source country taxes if the source country responds to the limitation of tax competition by re-imposing its tax. But the key is that the income has already been taxed, so that no double non-taxation ensues even if taxpayers do not declare the income (in the case of passive income, where the residence rate may be higher) or source countries choose not to tax in the case of active income. The sections that follow further develop this Article's reconsideration of the benefits principle.

## II. FATCA, IGAs AND MAATM<sup>16</sup>

In 2010, the United States revolutionized the international taxation of individuals with the enactment of FATCA. The Act arose as a response to the UBS AG aiding and abetting tax evasion by U.S. citizens.<sup>17</sup> FATCA imposes a 30% withholding tax on the U.S. source income of any "foreign financial institution" that has not shared information on its account holders who are U.S. citizens or residents.<sup>18</sup> In response, foreign banks and other financial institutions strongly objected to the policy for two main reasons.

First, banks claimed that it imposed unreasonable compliance costs.<sup>19</sup> The fundamental problem stems from the fact that the United States has since 1861 taxed its citizens living permanently overseas, and as a result, FATCA applies to many such expatriates who have no intention of hiding their income from the IRS (in fact, most of them do not owe any taxes to the United States because of the earned income exclusion of the Internal Revenue Code (IRC) section 911<sup>20</sup> and the foreign tax credit of IRC section 901<sup>21</sup>). This complaint could be addressed by stopping the taxation of citizens living overseas.<sup>22</sup>

<sup>16</sup> This section is based in part on Avi-Yonah and Gil, *IGAs vs. MAATM*, *supra* note 4.

<sup>17</sup> See Reuven S. Avi-Yonah, *What Goes Around Comes Around: Why the US is Responsible for Capital Flight (and What it Can Do about It)*, 2–3 (U of Michigan Public Law Research Paper No. 307, 2013), <http://ssrn.com/abstract=2208553>.

<sup>18</sup> I.R.C. § 1471 (2015).

<sup>19</sup> See Grinberg, *The Battle over Taxing Offshore Accounts*, *supra* note 4, at 304, 336.

<sup>20</sup> I.R.C. § 911 (2015); see also Internal Revenue Service, *Foreign Earned Income Exclusion – Requirements*, I.R.S.GOV, <http://www.irs.gov/Individuals/International-Taxpayers/Foreign-Earned-Income-Exclusion—Requirements> (last updated May 14, 2015).

<sup>21</sup> I.R.C. § 901 (2015).

<sup>22</sup> See Reuven S. Avi-Yonah, *The Case Against Taxing Citizens* (March 25, 2010). University of Michigan Law Sch. Empirical Legal Studies Ctr., Working Paper No. 10-009, 2010; University of Michigan Law Sch. Pub. Law & Legal Theory Working Paper Series, Working Paper No. 190, 2010), <http://ssrn.com/abstract=1578272>

The second problem with FATCA was that many foreign countries have taxpayer confidentiality laws that preclude banks from sharing account information with the IRS. Under the modern version of Article 26 of tax treaties and the Tax Information Exchange Agreements (TIEAs), such prohibitions should not bar the exchange of information, but many treaties have not been updated to reflect the new norms. Consequently, the banks argued that they faced a serious dilemma of either violating the laws of their home country or being subjected to the FATCA penalty.

The U.S. Treasury responded by negotiating a series of IGAs with the governments of various countries with which the United States has either a tax treaty or a TIEA. Under the IGAs, foreign governments are responsible for collecting the necessary information from their banks and for transmitting the information to the IRS. In return, under some IGAs, the United States has agreed to collect information on its residents who have accounts in U.S. banks and share it with the foreign governments. The difference, of course, is that the United States taxes its citizens living overseas, so it has many more taxpayers with accounts in foreign financial institutions than the foreign country is likely to have in U.S. banks.<sup>23</sup>

It is not clear that the IGAs are permitted under FATCA because the legislation requires direct submission of the information by the Foreign Financial Institutions (FFIs) to the IRS. Nor is it clear that the Treasury has the authority to enter into IGAs under the tax treaties and TIEAs.<sup>24</sup> But the main concern about the IGAs is that they enshrine the bilateral model of tax information exchange that has dominated the twentieth century.

There are good reasons to believe this bilateral model does not work, especially when IGAs are signed with countries, such as the Cayman Islands,<sup>25</sup> that have no interest in reciprocity. The alternative is MAATM. In response to the Financial Crisis and the outrage it caused in Europe about tax evasion by the wealthy, the OECD proposed MAATM,<sup>26</sup> which provides for the automatic exchange of information and appears to overcome the problem of non-reciprocity that bedevils the tax treaties, bilateral TIEAs, and IGAs.

### A. *The Scope of the Tax Evasion Problem*

Technological advances have made it easier for companies and individuals to shift income and capital among countries to reduce their global tax

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<sup>23</sup> See Reuven S. Avi-Yonah, *The Case Against Taxing Citizens*, 58 TAX NOTES INT'L 389 (2010).

<sup>24</sup> See Allison Christians, *The Dubious Legal Pedigree of IGAs (and Why It Matters)*, 69 TAX NOTES INT'L 565 (2013).

<sup>25</sup> For a list of TIEAs, see OECD, Tax Information Exchange Agreements (TIEAs), <http://www.oecd.org/ctp/harmful/taxinformationexchangeagreementstieas.htm> (last visited Feb. 5, 2014).

<sup>26</sup> OECD, *Convention on Mutual Administrative Assistance in Tax Matters* (June 2011), <http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf> [hereinafter MAATM].

amount by using tax haven jurisdictions. The OECD has recognized this phenomenon as a Harmful Tax Competition.<sup>27</sup> Although the ability of individuals to shift their capital income without being taxed is subject to substantial limitations,<sup>28</sup> capital-income shifting still exists, especially in situations where the taxpayer relies on the lack of information-sharing between different countries around the world<sup>29</sup> by not reporting her income.<sup>30</sup> In response, a significant effort has been made to force tax haven countries to share their information<sup>31</sup> about foreign taxpayers who utilize the lack of information exchanges between countries, while enabling the tax havens<sup>32</sup> to enjoy the investment of capital in their jurisdiction.

With the benefit of this information, tax researchers have been able to define the scope of the problem in terms of lost tax revenue. The Tax Justice Network, a non-profit organization, reports that the amount of equity held offshore by individuals alone was about \$11.5 trillion, with a resulting annual loss of about \$250 billion in taxes.<sup>33</sup> A study conducted by the Congressional Research Service indicates that tax evasion by individuals through setting up foreign corporations in tax havens and channeling the income to these foreign companies results in an estimated \$70 billion a year deficit to the U.S. Treasury.<sup>34</sup> Economist Gabriel Zucman used financial asset reporting to calculate an estimate of \$200 billion of lost income tax revenue per year worldwide,<sup>35</sup> which is significantly below other estimates, but provides a useful lower bound.

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<sup>27</sup> OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998), <http://www.oecd.org/tax/transparency/44430243.pdf> [hereinafter OECD, Harmful Tax Competition]. Under the OECD definition for tax havens, a country that does not share information about transactions that occurred within its jurisdiction is also a potential tax haven.

<sup>28</sup> See Reuven S. Avi-Yonah, *And Yet it Moves: A Tax Paradigm for the 21st Century* (University of Michigan Law Sch. Law & Econ. Working Papers, Working Paper No. 59, 2013), [http://repository.law.umich.edu/law\\_econ\\_current/59](http://repository.law.umich.edu/law_econ_current/59).

<sup>29</sup> See Reuven S. Avi-Yonah, *The OECD Harmful Tax Competition Report: A 10th Anniversary Retrospective* (University of Michigan Law Sch. Law & Econ. Working Papers Archive: 2003–2009, Working Paper No. 89, 2008), <http://law.bepress.com/umichlwps-olin/art89>.

<sup>30</sup> See JANE G. GRAVELLE, CONG. RESEARCH SERV., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 20 (2010), <https://www.fas.org/sgp/crs/misc/R40623.pdf>.

<sup>31</sup> See Avi-Yonah, *The OECD Harmful Tax Competition Report: A Tenth Anniversary Retrospective*, *supra* note 29, at 4–7.

<sup>32</sup> The OECD recognized that a country that does not provide information about its taxpayers is also a tax haven.

<sup>33</sup> Tax Justice Network, *Briefing Paper – The Price of Offshore* (Mar. 2005), [http://www.taxjustice.net/cms/upload/pdf/Price\\_of\\_Offshore.pdf](http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore.pdf).

<sup>34</sup> GRAVELLE, *supra* note 30, at 29.

<sup>35</sup> GABRIEL ZUCMAN, *THE HIDDEN WEALTH OF NATIONS: THE SCOURGE OF TAX HAVENS* 31 (2015).

### B. Lack of Information

Tax evasion has become a central concern of the major economies around the world. Accordingly, the global finance system has developed agreements for the exchange of information to increase the ability of its tax systems (both civil and criminal) to enforce its rules on sophisticated taxpayers.<sup>36</sup> In particular, the OECD has targeted countries whose lack of transparency allows them to function as tax havens.<sup>37</sup> Just before the Financial Crisis, the first author argued that the OECD has achieved significant progress in the field of information exchange.<sup>38</sup> However, lack of transparency is still a major problem globally. As long as some countries provide tax shelters, the OECD may win the battle, but lose the war.

Our assessment is based on two factors. First, in a competitive financial world, some countries will always be willing to host trillions of dollars to attract investment in their infrastructures.<sup>39</sup> Second, sophisticated internal law, such as that which exists in the British Virgin Islands (BVI), facilitates tax evasion.<sup>40</sup> BVI laws “require no identification of shareholders or directors, and require no financial records.”<sup>41</sup> Thus, even if the BVI provides information about its taxpayers, it is unlikely that information will be useful.<sup>42</sup> Consequently, the taxpayer has no real concerns.

With the information-exchange problem in mind, the United States started signing bilateral treaties and TIEAs with countries around the world.<sup>43</sup> The United States signed over sixty bilateral treaties,<sup>44</sup> which usually permit the exchange of civil and criminal information.<sup>45</sup> In addition, the

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<sup>36</sup> See Kevin Jestin, *Mutual Legal Assistance in Tax Matters: Recent Trends and Challenge Ahead* 1 (2008) (unpublished manuscript), <http://visar.csustan.edu/aaba/Jestin2008.pdf>.

<sup>37</sup> See OECD, *Harmful Tax Competition*, *supra* note 27, at 28–29.

<sup>38</sup> See Avi-Yonah, *The OECD Harmful Tax Competition Report: A Tenth Anniversary Retrospective*, *supra* note 29, at 783, 783–84.

<sup>39</sup> Dhammika Dharmapala and James R. Hines Jr., *Which Countries Become Tax Havens?* 93 J. OF PUB. ECON. 1058–1068 (2009) (stating that tax haven countries are usually quite affluent).

<sup>40</sup> GRAVELLE, *supra* note 30, at 21.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> See Chris Horton, *The UBS/IRS Settlement Agreement and Cayman Island Hedge Funds*, 41 U. MIAMI INTER-AM. L. REV. 357, 372.

<sup>44</sup> Avi-Yonah and Gil, *IGAs vs. MAATM*, *supra* note 4, at 5.

<sup>45</sup> See IRS, *Internal Revenue Manual* pt. 5 ch. 21 § 2 (Dec. 17, 2013), [http://www.irs.gov/irm/part5/irm\\_05-021-002.html](http://www.irs.gov/irm/part5/irm_05-021-002.html). (“The U.S. has over [sixty] bilateral tax treaties with other countries, and over [twenty] Tax Information Exchange Agreements (TIEA) in effect with various countries and jurisdictions where a bilateral tax treaty is not in place. These treaties and agreements facilitate the exchange of information, and generally allow for mutual assistance for both civil and criminal investigations. The tax treaties allow for information exchange by specific request, and in most cases, through spontaneous and automatic exchanges as well.”).

United States signed TIEAs with over twenty countries.<sup>46</sup> However, the effectiveness of the TIEAs agreements is in doubt.<sup>47</sup>

Between 2006 and 2010, the United States and other countries exchanged 5111 information requests.<sup>48</sup> But only 894 were outgoing requests.<sup>49</sup> Two factors inhibited the outgoing requests. First, “most of these agreements are restricted to criminal matters, which are a minor part of the revenues involved and pose difficult issues of evidence.”<sup>50</sup> Second, the complexity of the information that the IRS is required to provide to get information discouraged outgoing requests.<sup>51</sup> Generally, the IRS must provide a specific taxpayer name to retrieve any information and the reason that the taxpayer is under investigation. For example, the United States signed a TIEA with the Cayman Islands in 2004. According to the TIEA, the United States must provide very specific information to the Cayman Islands to get information about a U.S. taxpayer.<sup>52</sup> As a result, the TIEA is more of a confirmatory than discovery tool.<sup>53</sup>

In addition to tax treaties, in 2001, the IRS established the Qualified Intermediaries (QI) Program.<sup>54</sup> Under the program, a QI, such as a bank, is required to identify the payment and, in some types of investments where the beneficiary is a U.S. resident or any profit is subject to withholding,<sup>55</sup> the QI must notify the IRS about the transaction without disclosing the name of the taxpayer.<sup>56</sup> The QIs are required to withhold any tax amount and send the payment to the U.S. Treasury.<sup>57</sup> UBS was a QI. After its scandal,<sup>58</sup> the effectiveness of the QI program was questioned.<sup>59</sup> Although UBS was a QI, instead of discovering the identity of the beneficiary account, the bank created shell companies for its clients in the Cayman Islands to hide their identities.

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<sup>46</sup> *Id.*

<sup>47</sup> See GRAVELLE, *supra* note 30, at 26.

<sup>48</sup> U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-730, TAX ADMINISTRATION: IRS'S INFORMATION EXCHANGES WITH OTHER COUNTRIES COULD BE IMPROVED THROUGH BETTER PERFORMANCE INFORMATION 22 (2011).

<sup>49</sup> *Id.*

<sup>50</sup> GRAVELLE, *supra* note 30, at 20.

<sup>51</sup> See U.S. GOV'T ACCOUNTABILITY OFF., GAO-11-730, TAX ADMINISTRATION: IRS'S INFORMATION EXCHANGES WITH OTHER COUNTRIES COULD BE IMPROVED THROUGH BETTER PERFORMANCE INFORMATION 8-10 (2011).

<sup>52</sup> Agreement between the Government of the United States of America and the Government of the Cayman Islands for the Exchange of Information Relating to Taxes, U.S.-Cayman Is., Nov. 29, 2013, <https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/treaties.aspx?loc=60367d5a-48c4-4b82-8fd6-fd6e00763d5d>.

<sup>53</sup> Horton, *supra* note 43, at 373.

<sup>54</sup> Susan C. Morse, *Qualified Intermediary or Bust?*, 124 TAX NOTES 471 (2009).

<sup>55</sup> See I.R.C. § 871(a) (2014). See I.R.C. § 862(a) (2010).

<sup>56</sup> See Morse, *supra* note 54, at 472.

<sup>57</sup> Lynnley Browning, *U.S. Tax Agency to Strengthen Program to Catch Offshore Tax Evasion*, N.Y. TIMES (July 15, 2008), <http://www.nytimes.com/2008/07/15/business/worldbusiness/15iht-15tax.14499852.html>.

<sup>58</sup> Lynnley Browning, *U.S. Ends Inquiry of UBS Over Offshore Tax Evasion*, N.Y. TIMES (Nov. 16, 2010), <http://www.nytimes.com/2010/11/17/business/17tax.html>.

<sup>59</sup> See GRAVELLE, *supra* note 30, at 26.



However, there has been some progress since 2008. For example, in 2009, UBS agreed to disclose about 4450 American clients suspected of using the bank's offshore services to evade taxes.<sup>60</sup> But this was a small fraction of the more than 24,000 U.S. accounts held by the bank. Moreover, only a small portion of the 4450 names were prosecuted.<sup>61</sup> In parallel, FATCA and the IRS's offshore voluntary compliance initiative have had some success. But both policies are inherently limited because they apply to only U.S. residents (including U.S. citizens) and can be avoided by putting assets in a bank that has no U.S. assets (hence avoiding FATCA penalty tax exposure) in a jurisdiction that does not comply with MAATM.

### C. *The Revenue Rule and Non-Assistance in the Collection of Taxes*

As the global economy becomes more interconnected, tax collection is becoming more complex. Even if a country has determined the right to tax liabilities of its taxpayers, collection can be a difficult task. When a taxpayer lacks any assets in the country that is trying to make the collection, very limited solutions are available to that country. For example, in *India v. Taylor*,<sup>62</sup> the government of India sought taxes from a company registered in the United Kingdom, but trading in India. The House of Lords held that India could not enforce its collection of taxes through a British court:

“[T]here is a well-recognized rule, which has been enforced for at least 200 years or thereabouts, under which these courts will not collect the taxes of foreign States for the benefit of the sovereigns of those foreign States; and this is one of those actions which these courts will not entertain.”<sup>63</sup>

In *United States v. Harden*,<sup>64</sup> the United States District Court for the Southern District of California held for a deficiency of \$639,500.15 against the respondent. When the United States tried to enforce the judgment, it could not locate any of the respondent's assets in a U.S. jurisdiction. Consequently, the United States tried to enforce the judgment in a Canadian court based on a Canadian contract. However, like the House of Lords in the United Kingdom, the Supreme Court of Canada held that no Canadian court would enforce the revenue laws of another country:

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<sup>60</sup> Lynnley Browning, *14,700 Disclosed Offshore Accounts*, N.Y. TIMES (Nov. 17, 2009), <http://www.nytimes.com/2009/11/18/business/global/18irs.html>.

<sup>61</sup> Zach Lowe, *Six Months Later: Still a Good Deal for UBS?*, THE AM LAW DAILY (Aug. 18, 2009), <http://amlawdaily.typepad.com/amlawdaily/2009/08/six-months-later-a-good-deal-for-ubs-.html>

<sup>62</sup> Government of India, Ministry of Finance (Revenue Division) v. Taylor, [1955] AC 491 (HL) (appeal taken from Eng.).

<sup>63</sup> *Id.*

<sup>64</sup> United States of America v. Esperanza P. Harden, [1963] S.C.R. 366 (Can.).

“[T]he argument that the claim asserted is simply for the performance of an agreement, made for good consideration, to pay a stated sum of money must also fail. We are concerned not with form but with substance, and if it can properly be said that the respondent made an agreement it was simply an agreement to pay taxes which by the laws of the foreign state she was obligated to pay.”<sup>65</sup>

Although countries may enforce private judgments in fields like torts and contracts, when they are faced with a request to force foreign judgments in criminal, antitrust and tax law, the request will be denied.<sup>66</sup> The obvious result is a decrease in the ability of countries to enforce their laws even when public policy is not an issue. This phenomenon arises, in part, from one country viewing the enforcement another country’s law within its territory as “an extraterritorial intrusion.”<sup>67</sup> In this respect, despite the dramatic evolution of international tax practice in the last decades,<sup>68</sup> cooperation between countries on a voluntary basis remains limited.

*D. Article 27 under the OECD Model of the Tax Convention on Income and Capital*

In January 2003, the OECD added Article 27—The Assistance in The Collection of Taxes—to its Model Tax Convention on Income and Capital.<sup>69</sup> Article 27 outlines rules for contracting parties who wish to collaborate in collecting taxes across country boundaries. A brief review of the rules reveals a painstaking process for collaboration.

Under paragraph 1, a country will provide assistance to the other country upon a request to collect taxes within the foreign country. According to the Commentaries on the Articles of the Model Tax Convention (CAMTC), paragraph 1 is very flexible and subject to negotiation among the contracting countries based on their local laws. In addition, according to the CAMTC, the article is an elective. The collection of taxes is not limited to the type of taxes covered by Article 2 and most importantly, is also enforceable against people who are not entitled to the benefits derived from the convention.

Paragraph 4 allows a contracting country to require temporary relief before a final judgment is made against the taxpayer to safeguard future collection. The aforementioned provision combined with paragraph 6 is very

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<sup>65</sup> *Id.*

<sup>66</sup> See William S. Dodge, *Breaking the Public Law Taboo*, 43 HARV. INT’L. L. J., 161 (2002).

<sup>67</sup> Alan R. Johnson, Lawrence Nirenstein & Stephen E. Wells, *Reciprocal Enforcement of Tax Claims Through Tax Treaties*, 33 TAX LAWYER 469, 470 (1980).

<sup>68</sup> See Reuven S. Avi-Yonah, *International Tax as International Law* (U. Mich. L. Sch. Law & Econ., Research Paper No. 7, 2004) (for the evaluation and the impact of the international law on the practice).

<sup>69</sup> See OECD, Articles of the Model Convention with Respect to Taxes on Income and on Capital, art. 27 (Jan. 28, 2003), <http://www.oecd.org/tax/treaties/1914467.pdf>.

interesting. According to paragraph 6, the “validity or the amount of a revenue claim of a Contracting State shall not be brought before the courts or administrative bodies of the other Contracting State.”<sup>70</sup> An interesting question is whether paragraph 6 should also apply when temporary relief is provided (e.g. seizure), and whether the foreign court has the right to determine whether the request is reasonable on the strength of the evidence. A review of the CAMTC supports the hypothesis that any judicial proceeding will take place in the country that asks for assistance in the collection of taxes.

*E. Article 27 – The U.S Treaties in Practice vs. the OECD Model*

The MAATM convention operates at the international level, similar to other multilateral conventions, such as the Geneva Convention. Another traditional way to address tax issues between countries is through bilateral conventions. Although the U.S model tax convention of 2006 lacks any reference to assistance in the collection of taxes, the United States has signed treaties that include provisions relating to assistance in collection of taxes in a foreign country.<sup>71</sup> These provisions appear in two forms: general enforcement and limited enforcement.<sup>72</sup>

General enforcement provisions outline general mutual assistance in the collection of taxes within a foreign country. This provision appears in treaties with Canada, Denmark, France, the Netherlands, and Sweden.<sup>73</sup> A review of paragraph 1 of Article 27 of the convention between the United States and Sweden<sup>74</sup> reveals that the assistance applies to any type of tax that is covered by Article 2. Paragraphs 2 and 3 of Article 27 stipulate that when a country files<sup>75</sup> a tax claim against a person’s assets in another country, the latter country will enforce the claim as if the liability were in its jurisdiction. Paragraph 4 states that “the assistance provided by the article shall not be accorded with respect to the citizens, companies, or other entities of the state to which the application is made, except when the enforcement is against a person who enjoyed the convention although he was not entitled to.”<sup>76</sup> The application of Article 27 varies from treaty to treaty. For example, under the tax convention between the United States and Canada<sup>77</sup> is not applicable

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<sup>70</sup> *Id.* at art. 27, ¶ 6.

<sup>71</sup> IRS, *Internal Revenue Manual*, *supra* note 45, at pt. 5 ch. 21 § 2.

<sup>72</sup> See Johnson et al., *supra* note 67, at 472–473.

<sup>73</sup> IRS, *Internal Revenue Manual*, *supra* note 45, at pt. 5 ch. 21 § 2.

<sup>74</sup> Convention Between the Government of the United States of America and the Government of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 27, Swed.-U.S., Sept. 1, 1994, S. TREATY DOC. NO. 103-29.

<sup>75</sup> See IRM 5.21.7.4, Mutual Collection Assistance Requests (MCAR) (Nov. 13, 2015) (outlining the procedure for filing a claim).

<sup>76</sup> *Id.*

<sup>77</sup> Tax Convention, art. 27, Canada-U.S. Sept. 26, 1980, as amended by the Protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997, [https://www.fin.gc.ca/treaties-conventions/USA\\_-eng.asp](https://www.fin.gc.ca/treaties-conventions/USA_-eng.asp).

against a Canadian citizen if, at the date of the tax deficiency, the taxpayer was a citizen of the Canada. Under this provision, the United States would have won the case of *United States v. Harden*.

Why does the United States vary its application of Article 27? The answer is hidden in the late 1960s, when a broad collection of provisions was deleted from the U.S model.<sup>78</sup> Three hypotheses can explain the withdrawal of the provisions: (1) the IRS performed very limited collection abroad under the treaties that included “general enforcement” provisions;<sup>79</sup> (2) during the years following World War II, countries were more sensitive to measures that could be expressed as a foothold in their territory;<sup>80</sup> and (3) there was a development of independent agreements that are more limited. As a result, the United States entered a collection provision only when a convention was renegotiated and assistance of tax collection provisions was included.<sup>81</sup>

Limited enforcement provisions outline assistance in collection of taxes where a person or entity enjoys the benefits provided by the treaty, even though they are not entitled. Consequently, the application of the provision is narrow and limited to very specific situations.<sup>82</sup> For example, a limited enforcement paragraph can be found under the U.S.-Iceland convention:

Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by that other State does not inure to the benefit of persons not entitled thereto.<sup>83</sup>

A similar approach can be found under the treaties with Luxemburg (1996), Germany (1989), Austria (1996), and the United Kingdom (2001).<sup>84</sup>

#### *F. Multilateral Conventions for Tax Collection Assistance*

Due to a historic problem of tax collection by countries within a foreign country, jurisdiction countries have begun to sign mutual agreements. The first agreement appeared in 1950 as a multilateral convention among Belgium, the Netherlands, and Luxembourg (the Benelux<sup>85</sup> countries) for tax

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<sup>78</sup> THE NEW US-BELGIUM DOUBLE TAX TREATY: A BELGIAN AND EU PERSPECTIVE 558 (Anne Van de Vijver, et al. eds., 2009).

<sup>79</sup> *Id.*

<sup>80</sup> See Grinberg, *The Battle Over Taxing Offshore Accounts*, *supra* note 4, at 314.

<sup>81</sup> Johnson et al., *supra* note 67 at 469–70.

<sup>82</sup> *Id.* at 475–76.

<sup>83</sup> Tax Convention, art. 25, Ice.-U.S., Oct. 23, 2007, S. TREATY DOC. NO. 110-17.

<sup>84</sup> See THE NEW US-BELGIUM DOUBLE TAX TREATY: A BELGIAN AND EU PERSPECTIVE, *supra* note 78, at 558.

<sup>85</sup> A collective name for Belgium, the Netherlands, and Luxembourg, especially with reference to their economic union.

collection assistance.<sup>86</sup> Under the convention, the Benelux countries agreed to enforce the collection of tax in their territory for the foreign country. In 1972, the Nordic convention was signed with similar principles.<sup>87</sup> Following the success of the Nordic convention, the OECD started to draft a new convention in 1988 to reverse the lack of cooperation between OECD countries in collecting taxes.<sup>88</sup> At first, only a few countries signed the convention.<sup>89</sup> Two decades later, the OECD opened the convention on MAATM<sup>90</sup> for signature. In the first two years, about fifty countries signed the MAATM convention. By 2016, the convention had over eighty signatories.

The MAATM convention is designed to create a global network that deals with tax evasion cases.<sup>91</sup> The model of the MAATM convention is based on a combination of tax exchange provisions and administrative assistance in the collection of taxes. Under the model, countries that have signed the convention enjoy “cross-border tax co-operation including exchange of information, multilateral simultaneous tax examinations, service of documents, and cross-border assistance in tax collection, while imposing extensive safeguards to protect the confidentiality of the information exchanged.”<sup>92</sup> One advantage of the convention is the flexibility that it offers to countries by reserving the right to provide no information or assistance in the collection of taxes.<sup>93</sup> A country can exclude the collection of taxes in its jurisdiction either at the time of signing, ratification, or a later date.<sup>94</sup> For example, Poland withdrew its reservations concerning assistance in tax collection when it joined the European Union.<sup>95</sup>

### G. *The Tax Evasion Problem Reconsidered*

The current state of affairs is as follows: the United States has FATCA and a set of bilateral IGAs, but FATCA has loopholes (most obviously, using a bank with no U.S. source income exposure). The IGAs have come under

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<sup>86</sup> Jestin, *supra* note 36 at 3.

<sup>87</sup> *Id.* at 3–4.

<sup>88</sup> *Id.* at 4.

<sup>89</sup> OECD, *Background brief: The Convention on Mutual Administrative Assistance in Tax Matters and New Protocol*, (June 5, 2012), <http://www.oecd.org/ctp/exchange-of-tax-information/backgroundbrieftheconventiononmutualadministrativeassistanceintaxmattersandnewprotocol.htm> [hereinafter OECD, MAATM Background].

<sup>90</sup> See MAATM, *supra* note 26; see also OECD, *Convention on Mutual Administrative Assistance in Tax Matters*, (Feb. 2016), <http://www.oecd.org/ctp/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm>.

<sup>91</sup> See generally Grinberg, *Breaking BEPS: The New International Tax Diplomacy*, *supra* note 5.

<sup>92</sup> OECD MAATM Background, *supra* note 89; OECD, *Updated Multilateral Tax Convention now Open to All Countries* (Nov. 2012), <http://www.oecd.org/ctp/exchange-of-tax-information/updatedmultilateraltaxconventionnowopentoallcountries.htm>.

<sup>93</sup> MAATM, *supra* note 26, at art. 30.

<sup>94</sup> OECD, MAATM’s flyer (June 5, 2013), [http://www.oecd.org/ctp/exchange-of-tax-information/ENG\\_Convention\\_Flyer.pdf](http://www.oecd.org/ctp/exchange-of-tax-information/ENG_Convention_Flyer.pdf).

<sup>95</sup> *Id.*; see also MAATM, *supra* note 26, at art. 30.

legal challenge in Canada and depend on actual government cooperation to be fully implemented. The Obama Administration won in court on the validity of regulations requiring U.S. banks to collect information on payments of interest eligible for the portfolio interest exemption,<sup>96</sup> but in the absence of knowledge about the true beneficial owners, it is not clear that this information will be of any use even if exchanged under the IGAs. Moreover, foreign governments that have signed IGAs can, in many cases, be expected to behave like they do under the older TIEAs: namely, pretend to cooperate, but not do so in practice.

The OECD has Article 27, but this has not been implemented in most treaties, and the United States has generally not included it in its treaties or its model. Nor is it clear that courts are willing to overturn the revenue rule, despite the United States Supreme Court's *Pasquantino* decision.<sup>97</sup> In addition, the problem with MAATM is two-fold: the United States has not ratified the convention so that it may become a huge tax haven for the rest of the world and even a small non-cooperating jurisdiction may be able to derail it.

#### *H. The Limits of BEPS Project in Addressing the Financial Secrecy Issue*

One of the missions of BEPS project is to ensure transparency, while promoting increased certainty and predictability. Action 5 focuses on the transparency of harmful tax practices in intellectual property (IP) regimes. Action 12 requires taxpayers to disclose their aggressive tax planning arrangements. Action 13 reexamines transfer pricing documentation. Despite these reports, the issue of financial secrecy has not received enough attention in the BEPS project. Bilateral and multilateral actions are needed to address the financial secrecy issue.

Since 2009, the Global Forum on Transparency and Exchange of Information for Tax Purpose has been the main international body working on the implementation of the international standards on tax transparency. The Forum currently has 130 members and fifteen international organizations participating as observers. The OECD explains:

There are two internationally agreed standards on exchange of information for tax purposes: Exchange of Information on Request (EOIR); Automatic Exchange of Information Portal (AEIOI). All member jurisdictions have committed to implementing the international standard on EOIR. More than [ninety] countries and jurisdictions have committed to implementing the new standard on

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<sup>96</sup> See *Florida Bankers Ass'n v. U.S. Dept. of the Treasury*, 799 F.3d 1065 (D.C. Cir. 2015).

<sup>97</sup> See, e.g., *European Community v. RJR Nabisco, Inc.*, 424 F.3d 175 (2nd Cir. 2005) (limiting the scope of *Pasquantino v. United States*, 544 U.S. 349 (2005)).

AEOI. Work is currently underway to implement this Standard, with the first exchanges occurring on a very ambitious timeline of 2017 and 2018.

The global standard for automatic exchange of financial account information was approved by the OECD Council on July 15, 2014. Under the standard:

[Jurisdictions] obtain financial information from their financial institutions and automatically exchange that information with other jurisdictions on an annual basis. It sets out the financial account information to be exchanged, the financial institutions required to report, the different types of accounts and taxpayers covered, as well as common due diligence procedures to be followed by financial institutions.

Although AEOI will facilitate the discovery of some tax evasion, there is a long way to go to eliminate the information asymmetry created or exacerbated by domestic financial secrecy regimes and practices. For instance, as Switzerland is “the old grand-daddy of tax havens” the surprising demise of Switzerland’s legendary banking secrecy regime was not easy to achieve. As observed by political economy professor Patrick Emmenegger:

Switzerland is structurally dependent on the economic welfare of its largest banks, and Swiss banks are again structurally dependent on access to the [U.S.] financial market. This advantage along with the [UBS scandal enabled the United States to compel] Switzerland to make a series of bilateral concessions on the banking secrecy. In [the] spring [of] 2012, Switzerland accepted group requests for client files by the [United States] in cases of administrative assistance. In December 2012, Switzerland had agreed in principle with the [United States] on how to implement FATCA. These Swiss concessions to the [United States] once again fueled multilateral efforts by demonstrating the continued need to act on banking secrecy and by providing a focal point for collective action.

The successful unilateral action by the United States against Swiss banks not only rooted out the barrier for the U.S. Department of Justice and the IRS to acquire the files of American taxpayers from the Swiss banks, but also paved the way for collective action to overcome Switzerland’s resistance to international tax cooperation. Switzerland adopted the Standard for Automatic Exchange of Financial Account Information in 2014.

But, the unanswered question is, if the United States withdraws its pressure on the next successor of Switzerland, what will be the effective strategy to make the multilateral actions sustainable and viable? Emmenegger believes the international community likely will have to wait for the next “demonstration effect” before new substantial improvements are possible.

Although we appreciate his concern about the challenge for the viability of multilateral actions, we do not believe the international community's only choice is to wait for the demonstration effect of another legal battle between a powerful residence country and another tax haven.

The modernization of international tax governance, including the global efforts in fighting against BEPS should neither count on the luck associated with the tax evasion scandal nor on any single white knight among the victim countries. Instead, the sustainable multilateral actions should be built upon the rule of law, including but not confined to rational core values, coherent institutional arrangements, and effective methodologies for achieving voluntary practices on the part of the governments, financial institutions, and taxpayers.

Public shaming of wrongdoing countries and financial institutions has been an effective solution to ensure the compliance of international tax law because of reputational concerns. To improve the credibility of the blacklist, the peer review process of AEOI group should be impartial, transparent, and inclusive. Each blacklisted country should have the opportunity to be heard and to explain before the final decision is made by the AEOI group.

In addition to the banking secrecy, other financial secrecy regimes, including anonymous trusts and foundations and shell companies held by nominal shareholders for anonymous shareholders, need to be regulated from the perspective of international tax law. Examined from the domestic law, either in the form of statutes or decided cases, the private relationships in the structure of anonymous trusts and foundations and shell companies are legal. However, the sole purpose of such legal structures is to avoid taxation created by tax law. While recognizing the validity of the private legal relationship based on anonymous structures, we urge the international community to restrict the abuse of anonymous structures for illegal BEPS purposes. All nominal owners of the taxable properties for the beneficiary owners should be obligated to report the information to the local tax authority, which shares such information with the tax authority in other jurisdictions. Of course, the confidentiality of such information should be well protected from being abused by irrelevant individuals or institutions.

### III. THE LIMITS OF THE BEPS PROJECT

On October 5, 2015, two years after announcing the Action Plan, the OECD and G20 released the final BEPS package of thirteen reports, which cover fifteen actions. The BEPS package represents the first substantial renovation of international tax standards in almost a century. Its mission is to align the location of taxable profits with the location of economic activities and value creation. Some generally accepted principles of international tax law, including the single tax principle, the benefit principle, the anti-discrimination principle, and the transparency principle are incorporated in the reports. Despite considerable progress, there are many shortcomings with the



BEPS project due to the short two-year framework. Hence, the BEPS project is not the final destination of international tax law reform. Rather, it is the first step toward the modernization of global tax governance in the long run.

*A. New Shoes on the Old Road: an Old Approach for the New Destination*

The primary problem with the BEPS project is that although the new destination has been defined, new principles and new rules have not been established. Instead, the old principles have been strengthened by a patch up of current rules. The core principle of international tax law is the single tax principle, which requires eradication of double taxation and double non-taxation. Unfortunately, governments and MNEs have focused on fighting double taxation at the expense of double non-taxation. As a result of this singular focus, the main theme of traditional international tax law has been the eradication of double taxation. Accordingly, the mission of the BEPS project is to prevent and eliminate the double non-taxation. As the G20 leaders note, “profits [should be] taxed where economic activities occur and where value is created.” In this respect, the new direction of international tax law reform in the BEPS project is to safeguard the single tax principle.

It is well known that the rickety international tax regime, including rules and underlying principles, is one of the primary root causes of BEPS opportunities. As a result, the new direction demands revolutionary changes to current approaches. The ideal roadmap for the BEPS project is supposed to replace the old principles with a new principle, and to redesign the rules based on the requirement of the new principle. Unfortunately, many old principles of international tax law have been preserved in the final BEPS package. This approach has substantially compromised the value of the new principle, and made the legal reform of international tax look more like the patch-up of existing rules and principles.

As a result of the patch-up, complete renovation of current international tax law has not happened and genuine new rules guided by the new principle have not been formulated. Instead, the patch-up work has produced complex, discretionary, uncertain, costly, and contradictory rules. It remains difficult to translate all the new rules into the reality. Moreover, even if the BEPS project is implemented as outlined, it remains possible new BEPS opportunities to arise or arbitrariness by tax authorities to compromise the implementation’s effectiveness. The BEPS project is also silent on the basic concepts of residence and source, and where profit should be considered to be earned. Without the support of new principles for new rules, it remains very challenging to achieve the new destination of aligning the taxation of MNE profits with economic activity.

*B. The Survival and Continuity of Notional and Illusionary Independent Entity Principle and Arm's Length Principle*

The traditional international tax law is designed and interpreted based on the assumption that the various constituent entities or members of MNE groups are independent of each other and conduct transactions with each other at arm's length. While criticizing the independent entity theory as a fundamental flaw of the existing rules, the BEPS Monitoring Group, an active tax advocate group, identified a new but implied approach in the G20 mandate to treat the MNE group as a single firm, and ensure that its tax base is attributed according to its real activities in each country. This approach means that the new destination of taxing MNEs where economic activities occur and value is created is unlikely to be achieved, without treating the MNE group as a single firm.

We support the single unitary entity principle. The G20 mandate could be interpreted as both a new direction and a new guiding philosophy, which requires all the BEPS actions should serve the purpose of taxing MNEs where economic activities occur and value is created in the most efficient manner. Unfortunately, the BEPS project did not make the implied principle explicit. Instead, it continued to emphasize the independent entity principle, while attempting to counteract its harmful consequences. Virtually all of the new rules of the BEPS package are still built on the notional principle of independent entity.

The orthodoxy of independent entity taxation has two basic assumptions. First, the members of the MNE group are regarded as equal, separate, and independent legal entities. Second, the contracts between the related parties in the MNE group are freely negotiated at arm's length, and the terms of the contract are fair and reasonable dealings. However, these assumptions do not really exist in commercial reality.

The primary commercial reality is that the MNE group operates more like a single, unitary entity or enterprise rather than separate independent entities or enterprises. This cohesion is made possible by the controlling power of the parent corporation. As traditional international tax law stubbornly insists on the old concept of independent entity, MNEs have been encouraged to incorporate dozens and even hundreds of affiliates all over the world to undertake aggressive BEPS schemes. Because of the controlling power of the parent corporation, it is unlikely to find a real arm's length transaction in the reality. In fact, the related party contracts within the corporate group are always concluded without genuinely free, competitive, and transparent bargaining and negotiations.

If the BEPS project is designed on the principle of single unitary entity, the BEPS countermeasure will be much more simple and effective, as inter-group transactions will be disregarded, and the profit or tax base will be attributed to its real activities which generate the profit and create the value in the jurisdictions. Unfortunately, many actions of the BEPS project, in-

cluding but not confined to Action 2 on hybrid mismatches, Action 7 on permanent establishment, and Actions 8–10 on transferring pricing, rely on the legal fictions of independent entity and arm's length transactions.

### *C. The Survival and Continuity of the Problematic Benefits Principle*

The OECD declared that the goal of BEPS package is “to tackle BEPS structures by comprehensively addressing their root causes rather than merely the symptoms. Once the measures are implemented, many schemes facilitating double non-taxation will be curtailed.” One of the root causes is traditional benefit principle, which has guided the allocation of global profits in the past decades, and has created many BEPS opportunities. Unfortunately, the BEPS project failed to replace the benefit principle. Instead, the BEPS package maintains residence jurisdictions for passive income and source jurisdictions for active income.

BEPS concerns will be more effectively addressed if passive income is primarily taxed at source and active income is primarily taxed at residence. This new philosophy will help build a win-win framework international tax governance that will benefit developed countries and developing countries. Moreover, the conflicts between the domestic demand for tax revenue and domestic policy to attract foreign direct investment will be better balanced, and the MNEs and domestic firms will be offered a level playing field.

### *D. Limited Inclusiveness and Multilateralism*

Global challenges need global solutions. BEPS, as a global concern, is made possible by uncoordinated tax rules at domestic and international levels. Accordingly, the global solutions need to be based on inclusive and multilateral global governance. This approach means that all countries should be offered equal opportunities to shape the outcome of the global solutions. Although the OECD and G20 have made great efforts in organizing many non-member countries and non-governmental organizations to participate in the development of the BEPS package, the inclusiveness and multilateralism of the BEPS project is limited.

Major OECD countries dominated the formulation of the BEPS package, which reflects compromise between developed countries. For instance, weak measures on controlled foreign companies (CFCs), interest deductibility, and innovation box schemes are favored particularly by the United Kingdom. Although over sixty countries were directly involved in the process of the BEPS project, they account for less than one-third of the 193 United Nations (UN) members. As MNEs have their taxable presence around the globe, including the non-participating countries, the effectiveness of the BEPS project is very limited. The tax competitions between participating and non-participating countries will continue. The race to the bottom and the unilateral actions taken by any jurisdiction could hurt all countries.

Although some developing countries were consulted for the BEPS project, their core proposals were not necessarily accepted by the BEPS package. As observed by independent commentators, “some key OECD countries opposed and succeeded in blocking the institutional reform proposal from developing countries at the [Third] International Conference on Financing for Development.” Less influential participating countries and more than 120 non-participating countries might be hurt due to the effect of negative spill-over arising from the implementation of the BEPS project. These countries are weak not only because of their limited influence in the renovation of the current rules, but also because of their limited experience and resources to enforce the BEPS actions.

The process of public debate and consulting was relatively insufficient. The BEPS Monitoring Group complains that they have been vastly outnumbered by the army of paid tax advisers and representatives of multinational enterprises. Although stakeholder interest, including invaluable interactions with business and civil society, saw more than 12,000 pages of comments received on the twenty-three discussion drafts published and discussed at eleven public consultations, it is unknown to what extent these valuable proposals have been adopted by the BEPS package. More importantly, detailed reasons for rejecting different proposals have not been published.

Given the impossibility of guaranteeing that countries and stakeholders really had equal opportunities to influence and shape the BEPS package, the OECD and G20 are not the truly global platform needed for comprehensive reform of international tax law. To transform the current BEPS project into truly global, coherent, coordinated, and inclusive actions, the UN should undertake the leadership in the next stage of international tax law reform.

The third paragraph of Article 1 of the Charter of the UN recognizes that the third purpose of the UN is to achieve international cooperation in solving international problems of an economic, social, cultural, or humanitarian character. The fourth paragraph of Article 1 of the Charter of the UN recognizes its fourth purpose is to “be a cent[er] for harmonizing the actions of nations in the attainment of these common ends.” We believe that the UN will be more qualified, impartial, transparent, credible, and influential than the OECD and G20 in rewriting and renovating the international tax rules including the BEPS countermeasures. All UN members have the right to be heard and represented in the process of international tax law reform.

We urge that the UN Convention of Anti-BEPS should be made as the cornerstone of the global response to BEPS in a more coherent, inclusive and multilateral manner. Compared with the partial multilateral approach of OECD and G20, the global BEPS actions launched by the UN will better address the BEPS concerns and restore the integrity of international tax principles of single tax, neutrality, transparency, and fairness.

*E. The Limits of Action 1*

The digital economy has greatly expanded the platform of commerce and reduced the cost of business transactions. However, the digital economy has also exacerbated BEPS risks. That is why the tax challenges of the digital economy were listed as the first top priority on the agenda of BEPS project. To address BEPS concerns in the context of the digital economy, the Action Plan of 2013 established the Task Force on the Digital Economy (TFDE), a subsidiary body of the Committee on Fiscal Affairs.

TFDE's core mission is to "identify the main difficulties that the digital economy poses for the application of existing international tax rules and to develop detailed options to address these difficulties, taking a holistic approach and considering both direct and indirect taxation." Regarding Action 1's focus on the tax challenges of the digital economy, the OECD states:

The report analyses BEPS risks exacerbated in the digital economy and shows the expected impact of the measures developed across the BEPS Project. Rules and implementation mechanisms have been developed to help collect value-added tax (VAT) based on the country where the consumer is located in the case of cross-border [business-to-consumer] transactions. These measures are intended to level the playing field between domestic and foreign suppliers and facilitate the efficient collection of VAT due on these transactions. Technical options to deal with the broader tax challenges raised by the digital economy such as nexus and data have been discussed and analyzed.

The TFDE identified certain specific issues generated by the key features of the digital economy that warrant attention from a tax perspective. These include: (i) "ensuring that core activities cannot inappropriately benefit from the exception from permanent establishment [PE] status, and that artificial arrangements relating to sales of goods and services cannot be used to avoid PE status"; (ii) "the importance of intangibles, the use of data, and the spread of global value chains, and their impact on transfer pricing"; (iii) addressing opportunities for tax planning by businesses engaged in VAT-exempt activities.

Although Action 1 "considered several options to address the broader tax challenges raised by the digital economy, including a new nexus in the form of a significant economic presence, none of these options were recommended at this stage." However, OECD and G20 countries have agreed to monitor developments and analyze data over time to address the tax challenges raised by developments in the digital economy.

Action 1 was unable to propose all the solutions to the BEPS concerns in the digital economy for the following two reasons. First, although the digital economy has exacerbated BEPS risks, it has not generated genuinely unique BEPS issues. Almost every BEPS issue is directly or indirectly rele-

vant to digital economy. Additionally, all the BEPS actions interconnect and interact with each other in the digital economy. Therefore, the ideal Action 1 report would focus on universal philosophy and methodology of the BEPS project from the perspective of digital economy. It is challenging and unwise for the TFDE to produce some unique measures in parallel with other measures of the BEPS project. Second, the staggered time frame of the BEPS Project makes it impossible for TFDE to foresee and analyze the effectiveness of the future BEPS package in addressing BEPS concerns in the digital economy. For the same reason, it is difficult for TFDE to “evaluate the ultimate scope of the more systemic tax challenges in the area of nexus, data, and characterization, and potential options to address them.”

However, the limitations of Action 1 report could be overcome by “continuing research on the broader tax challenges of the digital economy, and by proposing detailed and viable options to address those challenges, with appropriate focus on multi-sided business models and the participation of users and consumers in value creation.” On the one hand, TFDE needs to assist the implementation of other BEPS actions, such as Action 3 on CFC rules, Action 7 on artificial avoidance of PE, Actions 8–10 on transfer pricing. On the other hand, TFDE should update the Action 1 report based on the experience, performance and outcomes of the BEPS Project. As planned by TFDE, a supplementary report reflecting the outcomes of the continuing work will be finalized by December 2015.

We doubt whether the intended outcomes of the BEPS project would be available for assessment, given the fact that the implementation of the fifteen actions is a lengthy process domestically and internationally. In our opinion, the Action 1 report should be updated regularly based on the changing business models of digital economy.

#### *F. The Limits of Action 2*

The main purpose of hybrid mismatch arrangements is to generate excessive deductible interest payments via either intra-group or third party loan. In the Action 2 report, the OECD states:

Hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for instance, creating two deductions for one borrowing, generating deductions without corresponding income inclusions, or misusing foreign tax credit and participation exemption regimes. Country rules that allow taxpayers to choose the tax treatment of certain domestic and foreign entities could facilitate hybrid mismatches. While it may be difficult to determine which country has in fact lost tax revenue, because the laws of each country involved have been followed, there is a reduction of the overall tax paid by all parties

involved as a whole, which harms competition, economic efficiency, transparency and fairness.

To establish international coherence of corporate income taxation, the mission of Action 2 is to develop model treaty provisions and recommendations regarding the design of domestic rules to neutralize the effect (e.g., double non-taxation, double deduction, long-term deferral) of hybrid instruments and entities.”

The Action 2 report identifies a common approach that will facilitate the “convergence of national practices through domestic and treaty rules to neutralize the effects” of hybrid mismatch arrangements. The report provides internal law recommendations and an OECD Model treaty recommendation:

Internal laws [should] . . . deny a dividend exemption in respect of payments that are deductible in the country of residence of the payor, and to prevent taxpayers from using hybrid transfers to duplicate credits for source-country withholding tax. To avoid double taxation and to ensure that the mismatch is eliminated even where not all the jurisdictions have adopted the rules, the recommended rules are divided into a primary response and a defensive rule. The defensive rule only applies where there is no hybrid mismatch rule in the other jurisdiction or the rule is not applied to the entity or arrangement.

In addition, the Action 2 report proposes including a new provision in the OECD Model Tax Convention to ensure that an entity that is a hybrid entity under the tax laws of two treaty countries is eligible for treaty benefits in appropriate circumstances but that treaty benefits are not allowed for income that neither treaty country treats as income of one of its residents:

[These recommendations] will help to prevent double non-taxation by eliminating the tax benefits of mismatches and to put an end to costly multiple deductions for a single expense, deductions in one country without corresponding taxation in another, and the generation of multiple foreign tax credits for one amount of foreign tax paid. By neutralizing the mismatch in tax outcomes, but not otherwise interfering with the use of such instruments or entities, the rules will inhibit the use of these arrangements as a tool for BEPS without adversely impacting cross-border trade and investment.

The solutions of Action 2 are soft recommendations, instead of minimum standards. Although countries have agreed to a general tax policy direction in neutralizing the effects of hybrid mismatch arrangements, it is difficult to achieve the agreements on minimum standards at this stage. As a result, the Action 2 has to choose a common approach to encourage the

countries to converge over time through the implementation of the recommendation at the levels of internal law and bilateral treaties.

However, it is not clear how long it will take the countries to converge in a harmonized way because changes of domestic law are left to the free choice of sovereign states based on the consideration of complex factors including different legal traditions. Some jurisdictions might wish to continue to treat certain instrument as indebtedness, while others might continue to treat it as equity. For similar reasons, some jurisdictions will continue to treat certain hybrid entities and reverse hybrid entities as fiscally transparent conduits, while some jurisdictions will continue to treat them as separately taxable entities.

If a few countries are very slow in the convergence process, the whole process of convergence will be delayed. Although all countries may argue that their own measures or paths are consistent with the right direction of the BEPS project, the real consequences might depart from the direction originally decided by the BEPS project. Even worse, it is possible that a few jurisdictions will return to the race to the bottom. In this event, the original direction of neutralizing the effects of hybrid mismatch arrangements might be compromised in some jurisdictions.

We propose that the international community replace the common approach by global minimum standards. To better coordinate Action 2 with other relevant Actions, in particular on interest expense deduction limitations, CFC rules and treaty shopping, the latter Actions should also be upgraded to minimum standards.

### *G. The Limits of Action 3*

Many MNEs set up affiliated non-resident taxpayers, and route income of a resident enterprise through the non-resident affiliate. Although the OECD has not done significant work on CFC rules in the past, thirty countries participating in the BEPS project, including the United States introduced CFC rules and other anti-deferral rules to address the BEPS concerns. According to the OECD, "While CFC rules in principle lead to inclusions in the residence country of the ultimate parent, they also have positive spillover effects in source countries because taxpayers have no (or much less of an) incentive to shift profits into a third, low-tax jurisdiction."

As the CFC rules in many countries do not always counter BEPS in a comprehensive manner, Action 3 aims at upgrading the CFC rules. The report outlines building blocks of effective CFC rules, while recognizing that the policy objectives of these rules vary among jurisdictions. The report states, "The six building blocks includes definition of a CFC, CFC exemptions and threshold requirements, definition of income, computation of income, attribution of income and prevention and elimination of double taxation." Action 3 also "identifies the challenges to existing CFC rules posed by mobile income such as that from intellectual property, services and



digital transactions, and allows jurisdictions to reflect on appropriate policies in this regard.”

The recommendations of Action 3 are not minimum standards. The recommendations provide flexibility to implement CFC rules and design options that could be implemented to be compliant with EU law. However, they are “designed to ensure that jurisdictions that choose to implement them will have rules that effectively prevent taxpayers from shifting income into foreign subsidiaries.”

Strong CFC rules are supposed to play an important role in tackling BEPS schemes. Action 3 should serve as a backstop to transfer pricing and other rules. Unfortunately, the CFC rules in the Action 3 are very weak. The building blocks in this Action are soft recommendations based on best practices, instead of hard minimum standards. In particular, the threshold for defining CFC income is very low. The weak CFC rules could be explained by the stubborn insistence on the tax incentives by some OECD countries, in particular the United Kingdom. According to the BEPS Monitoring Group, the United Kingdom and other countries “believe their assertions that they wish to see effective solutions to the problem of taxation of MNEs.”

It is unlikely that Action 3 will effectively reduce and deter the motivation of MNEs to abuse the system of exemption or deferral of tax on foreign income, and to shift income from operating affiliates in source jurisdictions to the tax havens. Moreover, the race to the bottom is likely to continue to attract the headquarters of MNEs. Traditional tax havens will continue their behaviors, while other countries will be motivated to adopt low effective tax rates on foreign income or exempting such income altogether to attract foreign direct capital.

Although compromise is inevitable in the process of developing Action 3, the OECD and G20 should seek a win-win solution by maximizing the common denominator of international tax. We urge the international community to strengthen the weak CFC rules of Action 3, adopt full-inclusion CFC rules in the future, and replace the recommendations with minimum standards.

#### *H. The Limits of Action 4*

Although the tax rules have significant influence on the location of debt within MNE groups, the loopholes of international tax rules enable BEPS schemes to be achieved by excessive deductible payments such as interest and other financial payments. The MNEs can multiply the level of debt at the individual entity level via intragroup financing. The unregulated deductibility of interest expense can give rise to double non-taxation in inbound and outbound investment scenarios. Accordingly, the mission of Action 4 is to “develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense . . . and other financial payments that are economically equivalent to interest payments.”

The Action 4 report recommends an approach based on “a fixed ratio rule, which limits an entity’s net deductions for interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA), as measured under relevant tax principles.” This approach includes a “corridor” of possible ratios between 10% and 30% for adoption by countries. In addition, Action 4 includes factors that countries should take into account in setting their fixed ratio, including “[a] worldwide group ratio rule that allows an entity to exceed this limit in certain circumstances may supplement this approach.” Action 4 is expected to ensure that an entity’s net interest deductions are directly linked to the taxable income generated by its economic activities and foster increased coordination of national rules in this space.

As lower transaction cost and more business opportunities are the core features and advantages of the corporate group, it is extremely abnormal for the interest deductions to be greater in aggregate than each corporate group’s consolidated interest costs to third parties. Theoretically speaking, if the interest cost of intragroup loans is unreasonably higher than the loans from third parties, the group and its members would reduce the interest loans. But the reality does not support this logic. One of the pressure areas for the BEPS concerns is that intragroup debt usually exceeds the firm’s overall borrowing from third parties, and the interest deductibility is excessive. The limitation of deductions of interest should be strong enough to root out the BEPS opportunities.

Unfortunately, the Action 4 report is not minimum standard. It facilitates the convergence of national rules in the area of interest deductibility. Therefore, its success depends on voluntary coordination between and among countries on enacting new domestic rules. If the progress of implementation and operation of the recommendations is not satisfactory as anticipated, the effectiveness of this Action will be compromised. It is very challenging for the jurisdictions to address excessive deductible payments and competitiveness considerations and ensure that appropriate interest expense limitations do not themselves lead to double taxation.

More problematic is the substance of Action 4, which prioritizes an interest deduction cap within a suggested band of 10% to 30%, with the option of using apportioned consolidated interest costs if they are higher. The formula of fixed cap does not match best with every sector and firm. That is why the Action 4 report recognizes the need to develop suitable and specific rules that address BEPS risks in banking and insurance industries. Although it does make sense to respect the specific features of banking and insurance industries, other industries might also claim the special treatments from the BEPS project. It is not realistic to design the specific rules for every firm, industry, or sector.

Before the proposal of a fixed cap was adopted, there were other better proposals. For example, based on the doctrine of unitary entity, a proposal suggested apportionment of the MNE group’s consolidated interest expenses

based on EBITDA. However, the initial proposals have been “watered down to recommendations prioritizing a fixed cap.”

We recommend that interest deductions may not be greater in aggregate than each corporate group’s consolidated interest costs to third parties. The recommendations in Action 4 do not prohibit countries from seeking better alternative solutions for effective control of interest deductibility. If the countries have no choice other than following the default recommendation of a fixed cap on deductions, they should use the lowest limit to deter aggressive interest deductions by MNEs. In fact, even the lowest limit still falls in the range of unrelated loans. Furthermore, coordination is always important to prevent the MNEs from defeating all of the countries by abusing the different rules around the world.

### *I. The Limits of Action 5*

Harmful tax practices, especially preferential regimes together with a lack of transparency in connection with certain rulings, have been widely used by MNEs for artificial profit shifting. In response, the OECD has called for proposals “to develop solutions to counter harmful regimes more effectively, taking into account factors such as transparency and substance.” To advance this goal, the Forum on Harmful Tax Practices (FHTP) has been refocused to develop more effective solutions. The mission of Action 5 “is to revamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and requiring substantial activity for any preferential regime.”

The Action 5 report establishes a minimum standard based on an agreed methodology to assess whether there is substantial activity in a preferential regime. In the context of IP regimes, such as patent boxes, the “nexus” approach achieved consensus. The OECD explains:

This approach uses expenditures in the country as a proxy for substantial activity and ensures that taxpayers benefiting from these regimes did in fact engage in [R&D] and incurred actual expenditures on such activities. The same principle can also be applied to other preferential regimes so that such regimes would be found to require substantial activities where they grant benefits to a taxpayer to the extent that the taxpayer undertook the core income-generating activities required to produce the type of income covered by the preferential regime.

To improve the transparency of preference regimes, “a framework has been agreed upon for mandatory spontaneous exchange of information on rulings that could give rise to possible BEPS concerns.”

The harmful tax practices proliferating in many countries represent the major form of race to the bottom. Such practices have triggered and in-

created numerous BEPS opportunities. Hence, Action 5 is designed to effectively reverse the history of beggar-thy-neighbor, which damages all countries, including the jurisdiction with harmful tax practices. Different from the Actions 2 through 4, Action 5 establishes a minimum standard in terms of substance and transparency, and includes the results of the application of the elaborated substantial activity and transparency factors to a number of preferential regimes. Unfortunately, for a number of reasons, Action 5 continues to be too weak to be effective.

First, the effectiveness of implementation of Action 5 is still up to voluntary self-regulation and self-monitoring by individual countries. Irrational developed and developing countries could be addicted to harmful practices, in the name of national competitiveness or attracting international capital.

Second, although the work of the FHTP will be refocused to develop more effective solutions, no penalty could be imposed by FHTP. In fact, all forty-three preferential regimes reviewed by the FHTP “were inconsistent with the nexus approach.” However, there is no effective penalty against the violators. It remains very challenging for all countries to voluntarily bring their intellectual property regimes into compliance with the nexus approach.

Third, the application of the broad and general principles of nexus and substance to innovation boxes might create different and divergent standards and interpretations in different countries. The consideration of national competitiveness or specific domestic circumstances might lead to new forms of harmful preference regimes.

Fourth, some developed countries have set bad examples for the developing countries in fighting against the harmful practices. As observed by the BEPS Monitoring Group, “the [United Kingdom’s] strong defense of its ‘patent box’ introduced in 2012 resulted in a compromise . . . with Germany, based on a ‘modified nexus approach,’ and a transition to the new standard by 2021.”

As the harmful tax practices always end up hurting every country, we urge the international community to abandon the voluntary self-policing model, and to establish mandatory monitoring model based on transparency, accountability, condemnation, and even economic sanctions depending on the seriousness of the harmful schemes. Harmful tax practices are unjustified and immoral. They are against the core value of international tax law. Therefore, it is inadequate, and even inappropriate to require countries to conduct cost-benefit analyses of the harmful incentives.

Many countries still attempt to acquire the limited selfish benefit at the price of negative spill-overs on the other countries. The harmful tax practices themselves have demonstrated the failure of voluntary self-policing approach. All countries should be encouraged to behave themselves in terms of higher standards of transparency, monitoring, review, and accountability of tax incentives. If a country wants to win the global community’s trust, it must take the firm initiative. To activate the monitoring function of FHTP,

the mechanism of transparent investigation, impartial peer review, reasonable reward, and adequate sanction will be indispensable.

### *J. The Limits of Action 6*

As treaty abuse, especially treaty-shopping, may give rise to double non-taxation, treaty abuse is one of the most important sources of BEPS concerns. Although the Commentary on Article 1 of the OECD Model Tax Convention before 2015 included a number of examples of provisions to address treaty abuse, “[t]ighter treaty anti-abuse clauses coupled with the exercise of taxing rights under domestic laws are expected to restore source taxation” to some extent. Accordingly, Action 6 develops model treaty provisions and provides recommendations on the design of domestic rules to prevent granting treaty benefits in inappropriate circumstances.

The Action 6 report includes a minimum standard on preventing abuse (including abuse through treaty shopping) and new rules that “provide safeguards to prevent treaty abuse and offer a certain degree of flexibility regarding how to do so.” The rules first address treaty shopping, “which involves strategies through which a person who is not a resident of a State attempts to obtain the benefits of a tax treaty concluded by that State.” More targeted rules have been designed to address other forms of treaty abuse. Other changes to the OECD Model Tax Convention have been accepted to ensure that treaties do not inadvertently prevent the application of domestic anti-abuse rules. A clarification that tax treaties are not intended to be used to generate double non-taxation is provided through a reformulation of the title and preamble of the Model Tax Convention. The report also contains the policy considerations to be taken into account when entering into tax treaties with certain low or no-tax jurisdictions.

The Action 6 report outlines a three-part approach to counter treaty abuse. First, “countries would include in treaties a clear statement that tax evasion, avoidance, or treaty shopping is not condoned by the treaty countries.” Second, a “specific anti-abuse rule of limitation-on-benefits (LOB) will be included in the OECD Model treaty, to ensure that there is a sufficient connection between the entity and the country of residence.” Third, “a more general anti-abuse rule, based on the principal purposes of transactions or arrangements (the principal purposes test or PPT) will be included in the OECD Model treaty,” so as to address situations not caught under the LOB rule.

The three-part approach adopted by the Action 6 will help to counter treaty abuse, but LoB articles and PPT provisions have their own pros and cons. Although the LoB article is easily understood and applied, “a proliferation of treaty-specific varieties of LoB articles would lead to over complexity in the treaties or domestic legislation.” Although the PPT provision is general enough to cover all the treaty shopping schemes, its interpretation and application depends on discretionary decisions of the tax authorities or

the courts. Therefore, the success of PPT provision relies on the individual country's competence, expertise, and resources, especially the useful information relevant to the treaty shopping behaviors.

Unfortunately, many developing countries do not have the necessary capacity and information resources to make the best use of the PPT provision. To offer useful guidance and reference to the developing countries, we urge the OECD and G20 to publish all of the latest decided cases or rulings on the PPT article on a regular basis. To sharpen the competence of developing countries in applying the anti-abuse clauses, spontaneous, systematic exchange of information between treaty partners should be established to ascertain the prerequisites for the taxpayer to enjoy treaty benefits. A more ambitious, global, spontaneous, comprehensive, and systematic platform for exchange of BEPS data between and among all jurisdictions should be created in the future. CbCR is one of the important parts of this data bank.

Although the countries may vary substantially from each other in terms of the legislation framework, judicial interpretation tools, and administrative ability, all countries involved should do their best in endorsing the minimum standard of protection against treaty shopping. In this way, the model treaty provisions included in the Action 6 report will be better adapted to the specificities of individual states and the circumstances of the negotiation of bilateral conventions. To reduce the treaty renegotiation cost and prevent the emergence of new treaty shopping platforms, a clear and effective anti-abuse provision should be incorporated as the core article of the proposed multilateral convention.

Finally, another important issue is the policy considerations relevant to treaty entitlement of collective investment vehicles (CIVs) and non-CIV funds.<sup>98</sup> The OECD will continue to evaluate issues related to entitlement to treaty benefits by certain types of investment funds by early 2016.<sup>99</sup> But it is challenging to achieve a satisfied consensus on some key issues, as there are different definitions of CIV in different jurisdictions. Furthermore, CIV may be organized in different forms, including partnerships, agreements, trusts or incorporated entities.

### *K. The Limits of Action 7*

Current tax treaties "generally provide that the business profits of a foreign enterprise are taxable in a State only to the extent that the enterprise has in that State a [PE] to which the profits are attributable." As a result of this provision, the definition of PE in tax treaties determines whether a non-resident enterprise must pay income tax in another State.

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<sup>98</sup> See OECD, OECD/G20 BASE EROSION AND PROFIT SHIFTING PROJECT: PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES, 10, 18 (2014).

<sup>99</sup> JOINT COMMITTEE ON TAXATION, *supra* note 97, at 22.

[However,] in many countries, the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a distributor. In many cases, this encouraged MNEs to replace arrangements under which the local subsidiary traditionally acted as a distributor by "commissionaire arrangements" with a resulting shift of profits out of the country where the sales take place without a substantive change in the functions performed in that country. Similarly, MNEs may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.

To "address techniques used to inappropriately avoid the tax nexus, including via replacement of distributors with commissionaire arrangements or via the artificial fragmentation of business activities," Action 7 developed changes to the definition of PE in Article 5 of the OECD Model Tax Convention, which is widely used as the basis for negotiating tax treaties. According to the changes:

[I]f the agent habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise in the name of the enterprise or for the transfer of, or the granting of the right to use, property of the enterprise or for the provision of services by the enterprise, the enterprise will be deemed to have a PE. A person who acts exclusively or almost exclusively on behalf of one or more closely related enterprises is not considered an independent agent. The exceptions from creating a fixed place of business for specific activities (such as storage, display or delivery of goods) apply only if the overall activity of the fixed place or business is of a preparatory or auxiliary character.

Although Action 7 developed changes to the definition of PE in Article 5 of the OECD Model Tax Convention, the changes are not substantially innovative. This is because the definition of taxable presence still rests on the obsolete PE concept, which requires physical presence for a period of six or twelve months in relation to the particular activity generating the profit attributable to it.

Both the traditional PE definition and the proposed changes in Action 7, are based on the independent entity principle. Without disconnection between the taxable presence and the independent entity principle, it is unlikely to make ground breaking groundbreaking progress in changing the

definition of PE. Action 7 only targets abuse of the PE definition, instead of rewriting the definition of PE itself. However, not all forms of abuse are covered in this Action. The anti-fragmentation rule in Action 7 is only applicable to artificial fragmentation of sales functions, but not to the artificial fragmentation of non-sales-related functions. This means that MNEs will be free to continue fragmentations of non-sales-related functions, and attribute higher profits to tax havens.

According to the findings of the BEPS Monitoring Group, the proposals of Action 7 could only affect some MNEs, such as those engaged in internet-based selling and which own warehouses in the country of sales. However, the proposals would not “deal with sales of immaterial products, or services, so they would affect physical but not electronic books, and DVDs but not streaming services.” In fact, the MNEs have already restructured their production chains to separate basic manufacturing, which can be allocated a “routine” profit, from functions such as R&D or design, which may be considered high-value-adding, and “can be located where they will be lightly taxed.” Even the rules against artificial fragmentation of sales functions have some loopholes. For instance, although an entity will be deemed to have a PE, if activities can be said to be “preparatory or auxiliary” to sales, the terms “preparatory or auxiliary” are not clearly defined. Therefore, uncertainties and disputes are likely to arise in the future.

It should be noted that there are different legal rules in the agency, especially the indirect agency in the civil law families and the common law families. Different jurisdictions may have different definitions of the agent. In European civil law jurisdictions, a commissionaire acts in its own name for the account of a principal, but no relationship is created between the customer and the principal. “As a commissionaire is not generally viewed as a dependent agent by virtue of the commissionaire status, the activities and place of business of a commissionaire are not attributed to the principal in civil law jurisdictions. However, such arrangement could create agency in common law countries.” Therefore, the anti-fragmentation rule should adopt a functional approach, which should be compatible with the different legal traditions of agency law in different countries.

According to the Action 7 report, follow-up works will be undertaken to provide additional guidance on profit attribution to the PEs resulting from the proposed changes, and to incorporate the proposed changes into the Model Tax Convention. For the latter work, additional clarification on the new treaty wording should be provided, any unintended consequences of the changes should be addressed, and the BEPS issue related to the global trading of financial products should be considered. We urge that the limited scope of the anti-fragmentation rule will be expanded to cover all the schemes of abuse of the PE definition. If possible, the continuing work should also reconsider the fundamental weakness of the ‘functionally separate entity’ approach and reorient the future reform of anti-fragmentation based on the single and unitary entity principle.



*L. The Limits of Actions 8–10*

A major BEPS concern is transfer pricing. Transfer pricing rules, which are described “in Article 9 of tax treaties based on the OECD and UN Model Tax Conventions and the Transfer Pricing Guidelines, are used to determine on the basis of the arm’s length principle the conditions, including the price, for transactions within an MNE group.” Transfer pricing rules allocates income earned by a MNE among the countries in which the company does business.

However, the existing transfer pricing rules fail in prices and efficient allocation of the income of MNEs among taxing jurisdictions. Some MNEs have been able to use and/or misapply those rules to separate income from the economic activities that produce that income and to shift it into low-tax environments. This most often results from transfers of intangibles and other mobile assets for less than full value, the over-capitalization of lowly taxed group companies, and from contractual allocations of risk to low-tax environments in transactions that would be unlikely to occur between unrelated parties.

Given that “special measures, either within or beyond the arm’s length principle, may be required with respect to intangible assets, risk and over-capitalization to address these flaws,” the mission of Actions 8, 9, 10 is to assure that transfer pricing outcomes are in line with value creation. The existing standards in this area have been clarified and strengthened, including the guidance on the arm’s length principle, and an approach to ensure the appropriate pricing of hard-to-value intangibles has been agreed upon within the arm’s length principle. Action 8, Action 9 and Action 10 are closely connected to each other in this area.

As misallocation of the profits generated by valuable intangibles has heavily contributed to BEPS concerns, Action 8 “develop[s] rules to prevent BEPS by moving intangibles among group members. This approach involves:

- (i) adopting a broad and clearly delineated definition of intangibles; (ii) ensuring that profits associated with the transfer and use of intangibles are appropriately allocated in accordance with value creation; (iii) developing transfer pricing rules or special measures for transfers of hard-to-value intangibles; and (iv) updating the guidance on cost contribution arrangements.

Action 8 examines transfer pricing issues relating to controlled transactions involving intangibles, since intangibles are by definition mobile and they are often hard-to-value. To assure the appropriate pricing of hard-to-value intangibles, Action 8 has devised an additional tool for countries to address the use of information asymmetry between taxpayers and tax authorities to undervalue intra-group transfers of intangibles.

Action 9 aims to “[d]evelop rules to prevent BEPS by transferring risks among, or allocating excessive capital to, group members.” This process involves “adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital.” The rules must align returns with value creation. Under Action 9, contractual allocations of risk are respected only when they are supported by actual decision-making and thus exercising control over these risks.

Action 10 aims to “[d]evelop rules to prevent BEPS by engaging in transactions which would not, or would only very rarely, occur between third parties.” This Action adopted transfer pricing rules or special measures to: “(i) clarify the circumstances in which transactions can be re-characterized; (ii) clarify the application of transfer pricing methods, in particular profit splits, in the context of global value chains; and (iii) provide protection against common types of base eroding payments, such as management fees and head office expenses.” Action 10 deals with the scope for addressing profit allocations resulting from controlled transactions which are not commercially rational, the scope for targeting the use of transfer pricing methods in a way which results in diverting profits from the most economically important activities of the MNE group, and the use of certain type of payments between members of the MNE group (such as management fees and head office expenses) to erode the tax base in the absence of alignment with the value-creation.

In aggregate, the Actions 8–10 report provides guidance on transfer pricing rules that better align operational profits with the economic activities which generate them. Additionally, the report contains “guidance on transactions involving cross-border commodity transactions and on low value-adding intra-group services.” Given the importance of these two areas to developing countries, “the guidance will be supplemented with further work mandated by the G20 Development Working Group, which will provide knowledge, best practices, and tools for developing countries to price commodity transactions for transfer pricing purposes and to prevent the erosion of their tax bases through common types of base-eroding payments.”

Actions 8–10 are the most important part of the BEPS project in addressing related party transactions of MNEs. Of course, the transferring pricing documentation requirements in Action 13 are also closely related to these three actions. The purpose of Actions 8–10 is to assure that transfer pricing outcomes are in line with value creation. The proposals on transfer pricing have made extensive revisions to the OECD Transfer Pricing Guidelines, which in fact will further strengthen the discretionary power for tax authorities to adjust them. Many proposals take the form of international standards, which could have some direct effects as international soft law.

Although the goal is correct, the approach of Actions 8–10 is very problematic. The solutions still focus on patch up of the dysfunctional rules built on the arm’s length principle, which again is rooted in the principle of sepa-

rate independent entity. According to the arm's length principle, all intra-group transactions are supposed to be rational and reasonable as commercial transactions between unrelated parties in comparable economic circumstances.

To implement the arm's length principle, Actions 8–10 make transfer pricing rules more sophisticated and complex, so as to authorize tax authorities to re-characterize the related party transactions within the MNE group. To find the available comparables, the tax authorities are required to make careful, informed judgement in good faith based on subjective analysis of detailed facts and circumstances relevant to the functions, assets, and risks actually undertaken by different group members located in different jurisdictions.

As the approach of Actions 8–10 is inevitably subjective and discretionary, the real effect of attribution of the tax base of MNEs will rely on the interactive bargaining and negotiation between MNEs and tax authorities. If the game is not fair enough, either under-taxation or over-taxation will arise. To avoid under-taxation, tax authorities will tend to maximize their discretionary power of re-characterizing, which might lead to the strong opposition from the MNE taxpayers. For the similar reasoning, to avoid over-taxation, MNEs might upgrade their aggressive BEPS schemes. As a result, both enforcement and compliance costs will be increased, and more disputes will be created. Moreover, as the subjective judgement will be made independently and separately by different national authorities, different jurisdictions might make conflicting re-characterization conclusions on the same intra-group transaction.

The complicated and uncertain approach of re-characterizing intra-group transactions is most challenging for the developing countries, as they do not have the necessary resources and expertise to administer the revised version of Transfer Pricing Guidelines. Of course, it is also very costly or even impossible for the developed countries to search for really precise and genuine comparables. Although the G20 Development Working Group promised to “help the developing countries to deal with the problem of lack of comparables,” it is not clear whether a simple, effective win-win solution on pricing method will be made available in the near future. We don't wish to see any form of one-sided solutions, including purely subjective discretion favored by tax authorities, and purely notational transfer pricing method favored by MNEs.

As indicated earlier, the principle of separate independent entity and the principle of arm's length are at most beautiful legal fictions, which do not actually exist in the commercial reality. In fact, even the terms of transactions between independent and unrelated parties are not necessarily fair and reasonable, if the two parties do not have equivalent negotiation powers on a level playing field. As the comparability analysis is not practical and feasible as anticipated, we propose the formulary apportionment system based on the single unitary entity principle. In other words, MNE group will be treated as

single and unitary entity, and all intra-group transactions will be disregarded. Compared with the approach of separate entity, this route will be more simple, direct, and effective in addressing the BEPS concerns arising from intra-group related party transactions.

In fact, the OECD has already noticed the proposed alternative income allocation systems, including formula based systems. Unfortunately, the OECD finally refused to replace the current transfer pricing system. The reason is not the flaw of the proposed alternatives, but the familiarity with the current approach and the reluctance to switch to new approach by launching ambitious reform. In the words of the OECD, “the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to the best course is to directly address the flaws in the current system, in particular with respect to returns related to intangible assets, risk and over-capitalization.”

As early as 2013, the OECD claimed that “there is consensus among governments that moving to a system of formulary apportionment of profits is not a viable way forward; it is also unclear that the behavioral changes companies might adopt in response to the use of a formula would lead to investment decisions that are more efficient and tax-neutral than under a separate entity approach”.

Although the US and some other states stubbornly defended and insisted on the dysfunctional arm’s length principle for transfer pricing adjustments and resisted alternatives, there is no credible evidence to indicate that 34 OECD members have reached clear and concrete agreement on unanimously opposing the system of formulary apportionment of profits based on the single entity principle. Moreover, there are no scientific research findings to indicate that the single entity approach has more weakness and less strength than separate entity approach.

To offer easy, certain, clear and predictable solutions to the BEPS concerns arising from transfer pricing, formulary apportionment methodology should be adopted, and the allocation of assets, payroll, sales and other factors need to be restructured and weighted. This will better allocate the tax base of MNE according to the location where economic activities and value creation take place. Needless to say, to make the formulary apportionment approach successful and sustainable, the principle of separate independent entity needs to be replaced by the principle of single unitary entity.

### *M. The Limits of Action 11*

As “significant data limitations severely constrain economic analyses of the scale and economic impact of BEPS,” improving the availability and analysis methodologies of data on BEPS is critical for the implementation of the BEPS project. The original title of Action 11 was “Establish methodologies to collect and analyze data on BEPS and the actions to address it.” This

action aims at “develop[ing] recommendations regarding indicators of the scale and economic impact of BEPS and ensuring that tools are available to monitor and evaluate the effectiveness and economic impact of the actions taken to address BEPS on an ongoing basis.”

The Action 11 report slightly adjusted the original title to “Measuring and Monitoring BEPS.” For data collection, the report defines BEPS as “arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place or by exploiting gaps in the interaction of domestic tax rules where corporate income is not taxed at all.”

The report constructed a dashboard of six BEPS indicators, including (1) the concentration of foreign direct investment (FDI) relative to GDP; (2) high profit rates of low-taxed affiliates of top global MNEs; (3) high profit rates of MNE affiliates in lower-tax locations; (4) effective tax rates of large MNE affiliates relative to non-MNE entities with similar characteristics; (5) concentration of royalty receipts relative to research and development spending; and (6) interest expense to income ratios of MNE affiliates in countries with above-average statutory tax rates. This dashboard provides strong signals that BEPS exists and suggests it has been increasing over time.

The research also finds significant non-fiscal economic distortions arising from BEPS, and proposes recommendations for taking better advantage of available tax data and improving analyses to support the monitoring of BEPS in the future, including through analytical tools to assist countries to evaluate the fiscal effects of BEPS and impact of BEPS countermeasures for their countries. Going forward, enhancing the economic analysis and monitoring of BEPS will require countries to improve the collection, compilation and analysis of data.

Although the final report of Action 11 conducted in-depth research on measuring and monitoring BEPS and offered recommendations on collecting and disseminating data to facilitate analysis of BEPS, there are some weaknesses. For instance, this report emphasizes that analysis of BEPS should not rely on any one indicator, and requires that the indicators should be viewed collectively to determine the scale and scope of BEPS. It is impossible for each of the six indicators to have equal weight in each and every jurisdiction. Unfortunately, this report has not offered a scientific and reliable formula of differentiating the separate weights of the six indicators suitable for the jurisdictions.

This report offers recommendations concerning data collection and dissemination to facilitate the analysis of BEPS for participating countries, and proposes to collect new data under Action 5, 12 and 13. However, this report has not proposed publishing the CbCRs worldwide to make the transfer pricing information available to all countries and the public. We live in a society of big data. Unfortunately, this report has not offered satisfactory big data solution for the countries to use in a digital society. We believe that it is necessary to develop a big data deployment strategy, and set up a global

BEPS data bank as the basic platform for collecting, exchanging, disseminating and analyzing of BEPS information all over the world.

#### *N. The Limits of Action 12*

The availability of timely, targeted and comprehensive information on aggressive tax planning strategies is extremely essential to enable governments to quickly identify risk areas. However, such information is often unavailable to tax administrations. The lack of such information is one of the main challenges faced by tax authorities worldwide. While audits remain a key source of relevant information, they suffer from a number of constraints as tools for the early detection of aggressive tax planning techniques.

The mission of Action 12 is to require taxpayers to disclose their aggressive tax planning arrangements by developing recommendations regarding the design of mandatory disclosure rules for aggressive or abusive transactions, arrangements, or structures, taking into consideration the administrative costs for tax administrations and businesses and drawing on experiences of the increasing number of countries that have such rules.

The Action 12 report provides a modular framework of guidance for the countries to design and improve a regime that guarantees early information on aggressive or abusive tax planning schemes and their users. . . . The recommendations provide the necessary flexibility to balance a country's need for better and [timelier] information with the compliance burdens for taxpayers. It also sets out specific best practice recommendations for rules targeting international tax schemes, as well as for the development and implementation of more effective information exchange and [cooperation] between tax administrations.

The purpose of Action 12 report is to enable the governments to have early access to information, and to quickly respond to systemic tax risks through informed risk assessment, audits or changes to legislation or tax policies.

However, the recommendations on requirements for taxpayers to disclose their aggressive tax planning arrangements are not minimum standards. Countries are free to decide whether or not to introduce mandatory disclosure regimes. Currently, only seven countries have mandatory disclosure regime in their domestic legislation. As the recommendations are not universally mandatory, it is easy for the MNEs to avoid the mandatory requirements in certain jurisdictions by incorporation in another jurisdiction without such requirements. It is also possible for the jurisdictions to join the race to the bottom by refusing to adopt mandatory disclosure regime. In our opinion, mandatory disclosure rules should be introduced to each and every jurisdiction, and the liabilities for violation of the mandatory disclosure rules should be designed and enforced in fair and transparent manner.

*O. The Limits of Action 13*

For the administration of transfer pricing, the G20 and OECD carefully considered the asymmetry of information between taxpayers and tax administrations.<sup>100</sup> This asymmetry could “undermine[ ] the administration of the arm’s length principle and enhance opportunities for BEPS.”<sup>101</sup> In many countries, tax administrations do not have a whole picture of a taxpayer’s global value chain.<sup>102</sup> Divergences between approaches to transfer pricing documentation requirements could also increase the compliance costs for businesses.<sup>103</sup> For these reasons, “it is important that adequate information about the relevant functions performed by other members of the MNE group in respect of intra-group services and other transactions is made available to the tax administration.”<sup>104</sup>

Although MNEs demand transparency of tax law administration from the tax authorities, they are reluctant to be transparent to the tax authorities. BEPS opportunities are less likely to survive in a transparent international tax environment. Better-coordinated transfer pricing documentation can increase the quality of information provided to tax administrations and reduce the compliance burden on MNEs.<sup>105</sup> Therefore, it is urgent to “develop rules regarding transfer pricing documentation to enhance transparency for tax administration, taking into consideration the compliance costs for business.”<sup>106</sup> In this context, the MNEs should provide “all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.”<sup>107</sup>

The Action 13 report outlines “a three-tiered standardized approach to transfer pricing documentation, including a minimum standard on [CbCR].” The OECD summarizes the approach as follows:

First, the guidance on transfer pricing documentation requires [MNEs] to provide tax administrations with high-level information regarding their global business operations and transfer pricing policies in a “master file” that is to be available to all relevant tax administrations. Second, it requires that detailed transactional transfer pricing documentation be provided in a “local file” specific to each country, identifying material related-party transactions, the amounts involved in those transactions, and the company’s analysis of the transfer pricing determinations they have made with regard to those transactions. Third, large MNEs

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<sup>100</sup> See OECD, Action Plan on Base Erosion and Profit Shifting, *supra* note 97, at 22.

<sup>101</sup> *Id.*

<sup>102</sup> See *id.*

<sup>103</sup> See *id.*

<sup>104</sup> *Id.* at 23.

<sup>105</sup> See OECD, BEPS Project, Explanatory Statement, *supra* note 97, at 17.

<sup>106</sup> OECD, Action Plan on Base Erosion and Profit Shifting, *supra* note 97, at 23.

<sup>107</sup> *Id.*

are required to file a CbCR that will provide annually and for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued and other indicators of economic activities. The large MNEs refer to those with annual consolidated group revenue equal to or exceeding EUR 750 million. CbCRs should be filed in the ultimate parent entity's jurisdiction and shared automatically through government-to-government exchange of information. In limited circumstances, secondary mechanisms, including local filing can be used as a backup. An agreed implementation plan will ensure that information is provided to the tax administration in a timely manner, that confidentiality of the reported information is preserved and that the CbCRs are used appropriately.

Regarding implementation, the OECD recommended that the first CbCRs be required to be filed for MNEs' fiscal years starting from January 1, 2016, while acknowledging that some jurisdictions may need time to transform the reporting system into their domestic legislation.

For the first time, the three documentation tiers will require taxpayers to disclose "consistent transfer pricing positions, and will provide tax administrations with useful information" of the entire picture of MNE operation, and enable them to assess transfer pricing risks and make determinations about whether, where, when, and how audit resources can most effectively be deployed. By standardizing transfer pricing documentation across countries and limiting the need for multiple filings of CbCRs, "MNEs will also see the benefits in terms of a more limited compliance burden." According to the OECD, "anticipation of this reporting system has already begun to discourage aggressive tax planning."

The annual CbCR is the most important measure in Action 13 to ensure the minimum transparency of transfer pricing. However, there are some limits to it.

First, the threshold of EUR 750 million of annual consolidated group revenue is unreasonably high for the major MNEs in developing countries, although this threshold is tailor made for the need of developed countries. Such threshold will exclude many large MNEs from the CbCR requirement, and deprive developing countries of the access to the information of MNEs below the threshold. In fact, many large MNEs have annual consolidated group revenue less than EUR 750 million. Needless to say, some large MNEs will be motivated enough to manipulate their group revenue to a level of less than EUR 750 million. In our opinion, all MNEs should be subject to CbCR requirement.

Second, all of the transfer pricing documents are only required to be submitted to the tax authorities, but not to the public and civil society organizations. It seems that the philosophy of this institutional arrangement is to preserve the confidentiality of the information and to ensure the appropriate



use by the government. However, the commercial confidentiality is not strong enough to defeat the right of the public to information of BEPS. The relevant stakeholders and the public need to have access to the MNEs' transfer pricing documentation. The reason is very simple, BEPS could hurt other taxpayers and stakeholders in relevant jurisdictions. We believe that the BEPS concerns will be more effectively addressed with the active and informed participation of the stakeholders and the public based on disclosed transfer pricing. Under the public pressure and support, the domestic legislatures and tax authorities will be more diligent and competent in tackling the BEPS issues. Of course, a high level of transparency will also benefit the MNEs, as it will significantly reduce compliance burden, and will improve their public image of credibility in terms of BEPS concerns.

Third, the CbCRs are only required to file with the tax authority of the MNE's ultimate parent entity's jurisdiction, instead of all the tax authorities of the jurisdictions where the MNEs have taxable business presences. To ensure rapid availability of CbCRs, we urge the CbCRs to be shared automatically and simultaneously between and among all the interested jurisdictions which have good reason to believe the existence of taxable presences by MNEs. Of course, if the MNEs' transfer pricing documentation is made available to the public, the double standards will be totally rooted out.

Fourth, although the content of the CbCRs covers the major issues of transfer pricing, it is difficult to exhaust all the data needed by tax authorities to assess the BEPS concerns arising from transfer pricing. Necessary data should be added into the CbCRs on a regular basis.

#### *P. The Limits of Action 14*

The interpretation and application of novel BEPS rules could inevitably introduce elements of uncertainty. To minimize and control the uncertain outcomes and to remove double taxation as an obstacle to cross-border trade and investment, it is necessary to "develop solutions to address obstacles that prevent countries from solving treaty-related disputes under [the mutual agreement procedure (MAP)], including the absence of arbitration provisions in most treaties and the fact that access to MAP and arbitration may be denied in certain cases."

The Action 14 report outlines "a minimum standard with respect to the resolution of treaty-related disputes[, including] . . . a strong political commitment to the effective and timely resolution of disputes through the [MAP]. The Forum on Tax Administration (FTA) will continue its efforts to improve MAP through its recently established MAP Forum. According to the report:

The commitment also includes the establishment of an effective monitoring mechanism to ensure the minimum standard is met and countries make further progress to rapidly resolve disputes. In ad-

dition, a large group of countries has committed to quickly adopt mandatory and binding arbitration in their bilateral tax treaties. . . . It is expected that rapid implementation of this commitment will be achieved through the inclusion of arbitration as an optional provision in the multilateral instrument to be developed to implement the BEPS treaty-related measures.

MAP is the ideal win-win platform to effectively resolve treaty-related disputes between two countries. However, the MAP does not always work effectively, because any party in the dispute could block the MAP unilaterally.

Unfortunately, the Action 14 has not offered remedies for the deadlock of MAP. Although mandatory arbitration is the suitable remedy for the MAP deadlock, Action 14 has not proposed the minimum standard of mandatory arbitration. At most, this Action encourages the inclusion of arbitration as an optional provision in the multilateral instruments. As some jurisdictions might exclude the arbitration clause in their bilateral and multilateral tax treaties, mandatory binding arbitration should be included in all bilateral and multilateral tax treaties.

It is important to note that mandatory binding arbitration should be supported by clear and predictable substantive rules, due process of law, and impartial and competent arbitrators. In our opinion, each party may freely appoint one arbitrator. If the two parties are unable to collaborate in choosing the chief arbitrator, the arbitration body may appoint the chief arbitrator.

#### *Q. The Limits of Action 15*

The success of the BEPS project depends on a swift implementation of the measures. According to the OECD, "Some actions of the BEPS project have resulted in recommendations regarding domestic law provisions, as well as . . . changes to the Commentary to the OECD Model Tax Convention and the Transfer Pricing Guidelines. However, changes to the OECD Model Tax Convention are not directly effective without amendments to bilateral tax treaties." It would be very time-consuming and uncertain to amend the more than 3,000 bilateral treaties currently in existence on a treaty-by-treaty basis.

The Action 15 report explores the technical feasibility of a multilateral instrument to implement the BEPS treaty-related measures and amend bilateral tax treaties. It concludes:

[A] multilateral instrument is desirable and feasible, and . . . negotiations for such an instrument should be convened quickly. Based on this analysis, a mandate has been developed for an ad-hoc group, open to the participation of all countries, to develop the multilateral instrument and open it for signature in 2016. So far, about 90 countries are participating in the work.

The goal of Action 15 is to streamline the implementation of the tax treaty-related BEPS measures by drafting a multilateral instrument. Although this Action represents a significant step towards multilateralism, the proposed multilateral instrument has not been provided for debate. To make the multilateral instrument coherent, inclusive and feasible, the developing process should be open and transparent. Namely, the negotiations should be really on equal footing, the proposals should be published, all relevant stakeholders should be heard, and public debate should be meaningful.

However, participation in developing the multilateral instrument is voluntary, and participating countries are not obligated to sign it. This liberal approach intends to encourage more countries to participate in the development process. But it is uncertain how many countries will sign it in the end. If the participating countries are obligated to sign the multilateral instrument, many countries will be not interested in participation. This dilemma reflects inadequate multilateralism represented by the OECD. Therefore, we believe that UN is the most qualified multilateral platform to develop a universally binding instrument to address BEPS.

#### IV. RECONSIDERING THE INTERNATIONAL TAX REGIME: A MULTILATERAL SOLUTION

It is time to re-evaluate the benefits principle. Most of the current issues can be solved by taxing passive income primarily at source and active income primarily at residence. For passive income, the number of source jurisdictions is much smaller than residence jurisdictions. Because most individuals are relatively risk averse, portfolio investment flows overwhelmingly to a small number of jurisdictions: the United States, European Union, and Japan. If these jurisdictions could impose a withholding tax on all outbound payments, most of the problem of taxing passive income could be resolved. Crucially, money cannot stay in tax havens and earn decent rates of return, so the cooperation of tax havens is not needed, unlike in the case of the MAATM. This approach would address the Sam Wyly problem because all of the income of the trusts would be currently taxed where it is invested.<sup>108</sup>

For active income, about 90% of large multinationals are headquartered in G20 countries, and none of those countries have a corporate tax rate below 20%. If the G20 countries taxed their MNEs based on where the headquarters are located on a current basis and restricted the ability to move the headquarters, the problem of taxing active income would be largely resolved

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<sup>108</sup> While FATCA takes care of the Wyly problem to some extent, it can be avoided by using banks that have no U.S. exposure. MAATM is unlikely to solve this issue because Wyly and tax evaders like him could place the trusts in a non-cooperating jurisdiction.

as well. This approach would address the Apple and Caterpillar problems because their offshore income would be subject to current U.S. taxation.<sup>109</sup>

The precedent for this approach is the adoption of the CFC rules.<sup>110</sup> Before 1961, no country taxed the foreign source income of subsidiaries of its MNEs because residence countries believed they lacked both source and residence jurisdiction over foreign source income of foreign corporations. However, in 1961 the Kennedy Administration proposed taxing all income of CFCs by using a deemed dividend mechanism that was copied from the Foreign Person Holding Company (FPHC) rules.<sup>111</sup>

While this proposal was rejected, the resulting compromise (Subpart F) aimed at taxing income of CFCs that was unlikely to be taxed by source countries either because it was mobile and could be earned anywhere (passive income) or because it was structured to be earned in low-tax jurisdictions (base company income). Initially, the adoption of Subpart F seemed to have put U.S.-based MNEs at a competitive disadvantage because no other country had such rules. But gradually the picture changed. The United States was followed by Germany (1972), Canada (1975), Japan (1978), France (1980), the United Kingdom (1984), New Zealand (1988), Australia (1990), Sweden (1990), Norway (1992), Denmark (1995), Finland (1995), Indonesia (1995), Portugal (1995), Spain (1995), Hungary (1997), Mexico (1997), South Africa (1997), South Korea (1997), Argentina (1999), Brazil (2000), Italy (2000), Estonia (2000), Israel (2003), Turkey (2006), and China (2008). Many other countries, such as India, are considering adopting such rules. As a result, most of our trading partners now have CFC rules.

Moreover, the later adopters improved the U.S. approach in two principal ways. First, they rejected the deemed dividend mechanism, which can lead to many unforeseen complications, in favor of taxing the shareholders on a pass-through basis. Second, they generally explicitly incorporate the effective foreign tax rate into the determination whether a CFC will be subject to current tax. This approach is better than the U.S. rule that is based solely on the type of income because, after 1980, it became quite easy to earn active income that is not subject to tax.<sup>112</sup>

The result is that the CFCs of EU-based MNEs are generally subject to tax at similar or higher rates than U.S.-based MNEs<sup>113</sup> despite the non-taxation of dividends from active income under territoriality. This outcome is a classic example of constructive unilateralism. The United States led and

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<sup>109</sup> Some of the BEPS action items (8–10) seek to address the types of profit shifting engaged in by Apple and Caterpillar, but they are not very effective.

<sup>110</sup> We do not think unilateral action is possible on the evasion front, but as explained above coordinated withholding taxes by the United States and European Union should work.

<sup>111</sup> Reuven S. Avi-Yonah, *The Deemed Dividend Problem*, 4 J. TAXATION GLOBAL TRANS-ACTIONS 33 (2004).

<sup>112</sup> See Avi-Yonah, *Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State*, *supra* note 2, at 1577.

<sup>113</sup> See Reuven S. Avi-Yonah & Yaron Lahav, *The Effective Tax Rates of the Largest US and EU Multinationals* 5 (Law & Economics Working Paper 41, 2011).

others followed, and the end result is that most MNEs are subject to similar effective tax rates, with no competitive disadvantage or advantage.<sup>114</sup> The result is a world in which there is much less double non-taxation than in the absence of CFC rules.

Unfortunately, in the United States, Subpart F has been critically undermined by the adoption of check-the-box elections and the CFC-to-CFC exception, resulting in \$2 trillion of low-taxed accumulated earnings offshore by U.S.-based MNEs.<sup>115</sup> This accumulation cannot happen in other countries with tougher CFC rules, and is a major part of the explanation why despite rampant tax competition most OECD members did not see the sharp drops in overall corporate tax revenues that are seen in developing countries.

The main argument in favor of territoriality (exempting dividends paid by U.S. CFCs from tax upon receipt by their parents) is the lock-out problem. About \$2 trillion in low-taxed foreign source income are in CFCs that cannot repatriate the income because of the 35% tax on repatriations and the absence of foreign tax credits.<sup>116</sup> We know this is a real problem because of the effectiveness of the 2004–05 amnesty and because of various attempts by MNEs to avoid the rule (via inversions, “killer Bs,” and short-term loans).<sup>117</sup>

But it is less clear that the solution is a participation exemption. Why not abolish deferral and let the dividends flow back tax-free? This is a good opportunity for constructive unilateralism. No G20 country has a corporate tax rate below 20%. If the United States reduced the corporate tax to, say, 28%, and, at the same time, abolished deferral, other G20 countries, such as Germany or France, would likely follow suit.<sup>118</sup> These countries need the extra revenue more than the United States, and concerns about competitiveness would be alleviated by the United States making the first move, like they were in the original CFC context.

Other G20 countries have more effective CFC rules than the United States, and those CFC rules already act as a de facto worldwide system with a minimum tax. If the foreign tax is below a set level (e.g., 25% in Germany or 20% in Japan), the CFC rules kick in to tax the income. The result is that there is much less lock out because most low-taxed foreign income is taxed by the CFC rules. The change to a worldwide system would be much less radical than usually envisaged. This is why for both the United Kingdom and

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<sup>114</sup> *Id.*

<sup>115</sup> Kimberly A. Clausing, *The Effect of Profit Shifting on the Corporate Tax Base*, 81 TAX NOTES 3 (2016).

<sup>116</sup> *Id.*

<sup>117</sup> See STAFF OF S. COMM. ON PERMANENT SUBCOMMITTEE ON INVESTIGATIONS, 112TH CONG., REPATRIATING OFFSHORE FUNDS: 2004 TAX WINDFALL FOR SELECT MULTINATIONALS 5 (Comm. Print 2011).

<sup>118</sup> 28% is the rate in which a revenue neutral corporate tax reform can be achieved if we abolished the three major corporate tax expenditures (deferral, accelerated depreciation, and the domestic manufacturing deduction). See MOLLY F. SHERLOCK & MARK P. KEIGHTLEY, CONG. RESEARCH SERV., R43060, TAX REFORM IN THE 144TH CONGRESS: AN OVERVIEW OF PROPOSALS 3 (2016), <https://fas.org/sgp/crs/misc/R43060.pdf>.

Japan, there was no significant increase in repatriations after they adopted territoriality in 2009.<sup>119</sup>

But should the United States not adopt a minimum but lower tax on foreign source income for competitiveness reasons? This is what both the Obama and Congressman David Camp proposals envisage. Obama suggests a 28% corporate tax on domestic profits and a 19% tax on foreign income, while Camp proposed a 25% tax on domestic profits and a 12.5-15% tax on foreign income.

The problem, of course, is that such a gap would still encourage U.S.-based MNEs to shift profits overseas, with no repatriation tax to deter them. The United States can always fall back to such a system if needed. But, for now, we suggest taxing all income at the same rate, and if that rate has to be lower, so be it. As long as it is above 20% we do not think we will be outside G20 norms, and a rate in the 20% to 25% range will not put our MNEs at a significant competitive disadvantage given the effective minimum tax imposed by the CFC rules of our trading partners.

It is impossible to predict what will happen, but the history described above suggests that there is a good chance that other G20 countries will follow us if we abolish deferral at a lower rate.<sup>120</sup> If that happens, all the usual objections to worldwide taxation (competitiveness, inversions, and the various neutralities) lose their force. We do not think there is a significant risk involved in this move, and the potential upside is quite large.

## CONCLUSION

The benefits principle should be reconsidered in light of the reality of globalization. We should tax passive income primarily at source and active income primarily at residence. This approach will enable the large economies to address both individual tax evasion and corporate tax avoidance. These problems must be addressed if we are to continue to maintain and expand the benefits of globalization. The U.S. public support of globalization hinges on the existence of a social insurance safety net. If the rich and large corporations are not perceived to pay their fair share, the public's willingness to pay tax to support this safety net is eroded. Once a culture of not

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<sup>119</sup> Stephen E. Shay, J. Clifton Fleming & Robert J. Peroni, *Territoriality in Search of Principles and Revenue: Camp and Enzi* 141 TAX NOTES 173 (2013).

<sup>120</sup> See the most recent proposal of the EU Commission to tax currently CFC profits that are subject to an effective tax rate below 40% of the residence country rate if over 50% of the CFC's income is either passive or derived from sales to related parties. Council of the European Union, 14544/15, art. 9 (Dec. 2, 2015), <http://data.consilium.europa.eu/doc/document/ST-14544-2015-INIT/en/pdf>; see also European Commission, *Proposal for a Council Directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market*, COM (2016) 26 final; European Commission, *Anti Tax Avoidance Package*, COM (2016) 23 final. But see Christian Oliver & Jim Brunsten, *US blasts Brussels over tax probe bias*, FIN. TIMES (Jan. 29, 2016), <http://www.ft.com/cms/s/0/c63db5c8-c6b1-11e5-808f-8231cd71622e.html#axzz4CRV4Xfta>. Hopefully, the next U.S. Administration will take a more cooperative attitude.

paying taxes is established it is very hard to change. We need to do something about both tax evasion and avoidance before it is too late.